ICB Independent Commission on Banking

Issues Paper
Call for Evidence

September 2010

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Chapter 1: Introduction

Background

1.1 The global financial crisis that began in 2007 has exposed fundamental weaknesses in banking systems and related financial markets. Major financial institutions, including in the UK, were saved from failure only by massive government support schemes. Others were taken over by competitors, or collapsed. Markets for financial services have been seriously weakened, with implications for competition within them and to the continuing detriment of businesses and households in the wider economy.

1.2 Securing a stronger and better functioning financial system is the goal of a range of public policy initiatives. One set of measures aims to make banks individually more resilient to shocks, for example by requiring them to hold more capital relative to their lending activity and to have more robust access to liquidity at times of need. Other initiatives focus instead on "macro-prudential regulation" – measures intended to improve the stability of the financial system as a whole, including its resilience to cyclical developments.

1.3 There are also policy questions about the structure of banks, and of the markets in which they operate. For example, would reform to the structure of banks make them more resilient, and/or (like firms in other sectors) more able to fail without undue distress to the wider economy if they made poor business decisions? Can market structures, which the crisis has impaired, be made more competitive so that they serve customers better? In particular, can steps be taken to remove the inducement to continued excessive risk-taking – and unfair distortion to competition – arising from the perception, which the crisis has enhanced, that some institutions are "too big to fail" and therefore guaranteed by the public purse?

1.4 The Independent Commission on Banking (the Commission) was established by the Government in June 2010 to examine these and other questions about the structure of the UK banking sector, and to make recommendations by the end of September 2011 on structural and related non-structural measures to promote stability and competition in banking for the benefit of consumers and businesses. The terms of reference are on the Commission's website.[1]

1.5 The main purpose of this paper is to invite views on some basic questions that the Commission's recommendations will address in due course.

1 http://bankingcommission.independent.gov.uk/bankingcommission/terms-of-reference/

Call for evidence

1.6 The chapters that follow set out a brief description of the current state of the UK banking sector, go on to discuss the issues that the Commission has been asked to address, and then describe some examples of potential options for reform. While comments on any aspect of this paper are welcome, three topics on which the Commission would be particularly interested in receiving views, analysis and evidence are set out immediately below.

Topic 1: Objectives

1.7 The Commission's terms of reference require it to make recommendations to promote stability and competition in banking. Chapter 3 discusses these primary objectives and the complex question of how they are related. The chapter also discusses the other objectives to which the Commission is required to have regard, which include lending and the pace of economic recovery, competitiveness in financial services and the wider economy, and risks to the Government's fiscal position.

Question 1.1

What is the relationship between the Commission's two primary objectives of financial stability and competition (including consumer choice)? Are these goals fundamentally in harmony? If not, what are the tensions between them and how can reform proposals be designed to alleviate the tensions?

Question 1.2

What weight should the Commission give to the other objectives – on lending and the pace of economic recovery, competitiveness, and risks to the Government's fiscal position – in its analysis?

Topic 2: Possible reform options

1.8 Chapter 4 outlines a number of options for reform in broad terms, distinguishing between those that relate to the structure of banks and those that relate to the structure of markets. The list (below) does not aim to be exhaustive, nor at this early stage has the Commission moved towards any particular options.

Reform options related to the structure of banks

- Separation of retail and investment banking
- Narrow banking and limited purpose banking
- Limits on proprietary trading and investing
- Structural separability, including living wills and resolution schemes
- Contingent capital
- Structure-related surcharges

Reform options related to the structure of markets

- Measures to reduce market concentration
- Market infrastructure reform

Question 2.1

Are there other broad options for reform that should be added to this framework? For example, should any of the "other reform initiatives" listed in Paragraph 4.33 be matters on which the Commission should seek to make recommendations?

Question 2.2

Which (if any) of the reform options identified in the above framework most deserve further development, specification and analysis?

Topic 3: Benefits and costs of reform options

1.9 In the context of the other regulatory reform initiatives that are currently under way (for example, on capital and liquidity requirements), what would be the likely impact of the options referred to in the framework above (including any unintended consequences)? In particular:

Question 3.1

What would the benefits of these options be, in particular for financial stability and competition? How can these benefits be quantified?

Question 3.2

What would the likely costs be of the various options? For example, what lost efficiencies might there be if banks were required to reduce the range of activities they could undertake, and/or their size? How can these costs be quantified?

Question 3.3

What are the implications of the role of the (less regulated) shadow banking sector for the Commission's work? To what extent would the different reform options simply shift problems from the banking sector to the shadow banking sector?

Question 3.4

Should any of the broad options be ruled out as impractical? If so, why?

How to respond

1.10 The closing date for responses is 15 November, 2010. Responses should be sent by e-mail, if possible, to feedback@bankingcommission.gsi.gov.uk. Alternatively, they can be posted to:

Issues Paper Feedback
Independent Commission on Banking
Victoria House
Southampton Row
London
WC1B 4AD

1.11 All written representations and evidence provided to the Commission may be made public unless specifically requested otherwise. If you would like any of the information provided in your response to be treated confidentially, please indicate this clearly in a covering note or e-mail (confidentiality language included in the body of any submitted documents, or in standard form language on e-mails, is not sufficient), identifying the relevant information and explaining why it is confidential. Note that even where such requests are made, the Commission cannot guarantee that confidentiality will be maintained in all circumstances, in particular if disclosure should be required by law. Although the Commission has been advised that it is not subject to data requests under the Freedom of Information Act 2000, once it has completed its work its papers are likely to be passed to the Government and would then be subject to such requests. If you have any particular concerns about confidentiality that you would like to discuss, please contact the Commission using the e-mail address provided above.

1.12 Any personal data provided to the Commission will be held and processed only for the purposes of the Commission's work, and in accordance with the Data Protection Act 1998. Personal data will not be published or disclosed to a third party except as required by law. Once the Commission has completed its work then any personal data held by it is likely to be passed to the Government for the purpose of public record-keeping.

1.13 The views expressed in this paper are the views of the Commission only, and are not intended to represent the views of the Government or of any Government Minister or Department. The analysis set out in the paper has been produced by the Commission and its secretariat. The Commission is independent from the Government, and will report to the Cabinet Committee on Banking Reform by the end of September 2011.

Chapter 2: Where we are now

The UK banking sector

2.1 Activities undertaken by banks can be broadly separated into two categories: retail & commercial banking and wholesale & investment banking (definitions of these and other financial terms used in this paper are set out in the Glossary; a description of banks and banking activities is set out in Annex 1). Several of the largest UK-owned[1] banks are universal banks which undertake both broad categories of banking activity. Other UK-owned banks and mutual societies (principally building societies) focus on retail & commercial banking. The UK is host to a significant number of foreign-owned banks which operate here either through subsidiaries or branches; the focus of most of the large foreign-owned banks is on wholesale & investment banking.[2] Foreign-owned banks located in the UK account for almost half of total UK-resident banking assets.[3]

2.2 Accordingly, when making recommendations in relation to the "UK banking sector", the Commission will include within its scope not only the UK operations of UK-owned banks and mutual societies, but also foreign operations of UK-owned banks and UK operations of foreign-owned banks. Shadow banking institutions – such as hedge funds and securitisation vehicles – which are not regulated to the same degree as banks but which carry out some of the functions that are typically conducted by banks (such as maturity transformation) will be considered to the extent that they impact on the banking sector and/or the likely efficacy of the Commission's recommendations.

2.3 In addition to its international nature, a further prominent characteristic of the UK banking sector is that it is relatively concentrated, an attribute that has become more pronounced as a result of the financial crisis. There are approximately 340 banks in the UK. By way of comparison, France has around 390 banks, Germany around 2,000 banks and the US around 8,000.[4] The UK banking sector is especially concentrated in the retail & commercial banking sector, where the top six banks account for 88% of retail deposits. In France, it takes the top ten banks to account for 88% of retail deposits; in Germany the top seven banks account for 68%; and in the US the top eight banks

1 "UK-owned banks" are those banks whose ultimate parent is resident in the UK. "Foreign-owned banks" are all others.
2 Some foreign-owned banks – such as Santander – are also active in retail banking.
3 Bank of England, 2010, *Financial Stability Report Issue No. 27*.
4 Figures for European countries from the European Banking Federation: http://www.ebf-fbe.eu/index.php?page=statistics. Figure for the US from the US Federal Deposit Insurance Corporation: http://www.fdic.gov/bank/statistical/stats/index.html.

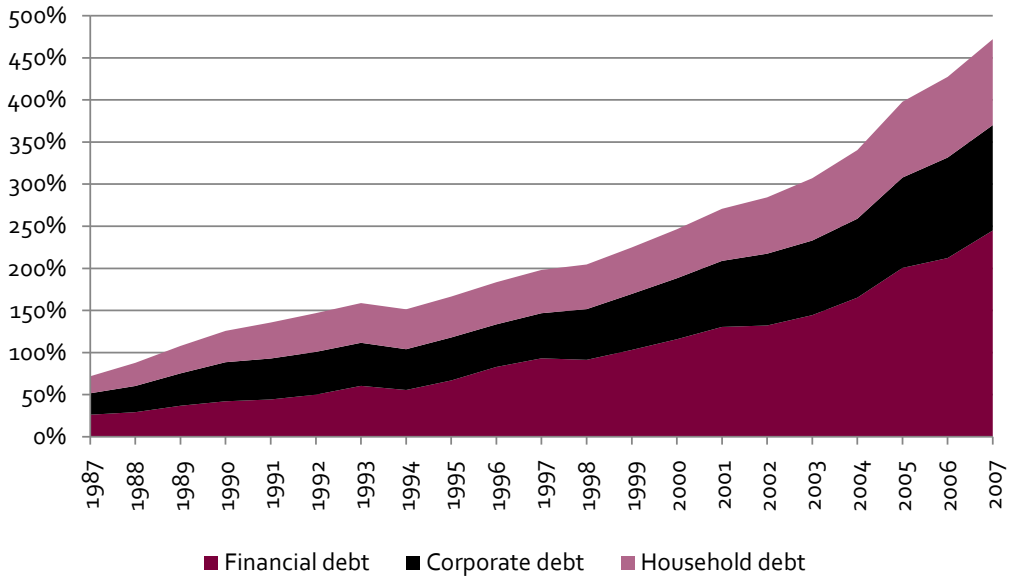
account for only 35% of the market.[5] In the UK market for investment banking services, the top ten firms generated around 65% of the total fee revenues in 2009.[6]

Recent trends

2.4 In formulating its recommendations, the Commission will not focus simply on putting forward policy proposals that are responses to the last crisis, as the next crisis will surely be different. However, the Commission's work will clearly involve consideration of the failings revealed by the experiences of the last few years, and so it is informative to look at a number of trends that were evident in the financial sector in the run-up to the crisis.

2.5 One of the most obvious trends was the explosion of debt.[7] In the twenty year period running up to the crisis, the aggregate debt of the UK financial, household and corporate sectors as a percentage of GDP increased more than sixfold, with a particularly striking rise in claims within the financial sector (see Figure 1).

Figure 1: UK debt as % of GDP, by borrower type

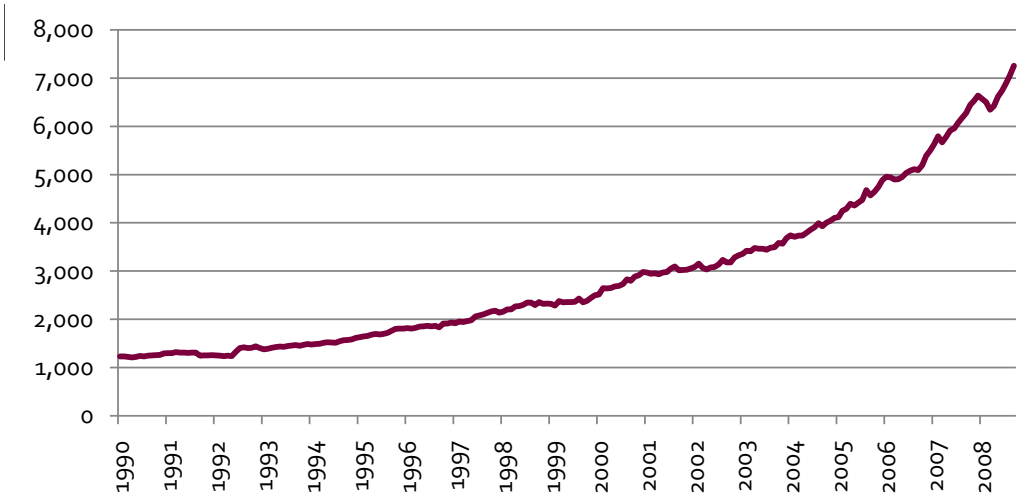


Source: Oliver Wyman

2.6 The same period also witnessed a rapid increase in the aggregate balance sheet of the UK banking sector (see Figure 2).

5 Figures from the Capgemini, UniCredit and EFMA *World Retail Banking Report 2009*.
6 Figure from Dealogic. The "UK market" covers transactions for which the client (or its ultimate parent company, if relevant) is UK-based.
7 Rapid increases in indebtedness and leverage have often preceded financial crises; see Reinhart, C.M. & Rogoff, K., 2010, *This Time Is Different: Eight Centuries of Financial Folly,* Oxford, Princeton University Press.

Figure 2: Aggregate balance sheet of UK banking sector (£bn)

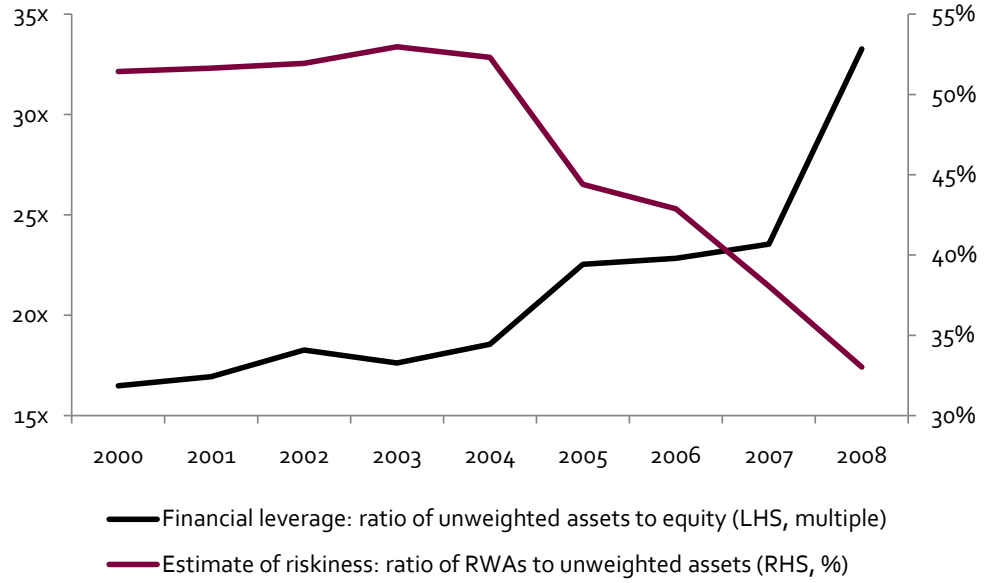


Source: Bank of England

2.7 The growth of UK debt and of banks' balance sheets was accompanied by an increase in banks' leverage. However, while the aggregate financial leverage (i.e. the ratio of unweighted assets to equity) of the four largest UK-owned banks increased, an estimate of the aggregate riskiness of their assets (the ratio of risk-weighted assets (RWAs) to unweighted assets) fell (see Figure 3). For this to have happened, banks must have re-balanced their portfolios into assets carrying lower risk weights,[8] at the same time as increasing their leverage. Subsequent events have shown that those lower risk weights did not represent an accurate assessment of the riskiness of at least some assets.

8 Note also that the change in accounting standards from UK Generally Accepted Accounting Practice to International Financial Reporting Standards in 2005 and the introduction of Basel II – which had the effect of reducing asset risk weights in many cases – are both likely to have had an impact here.

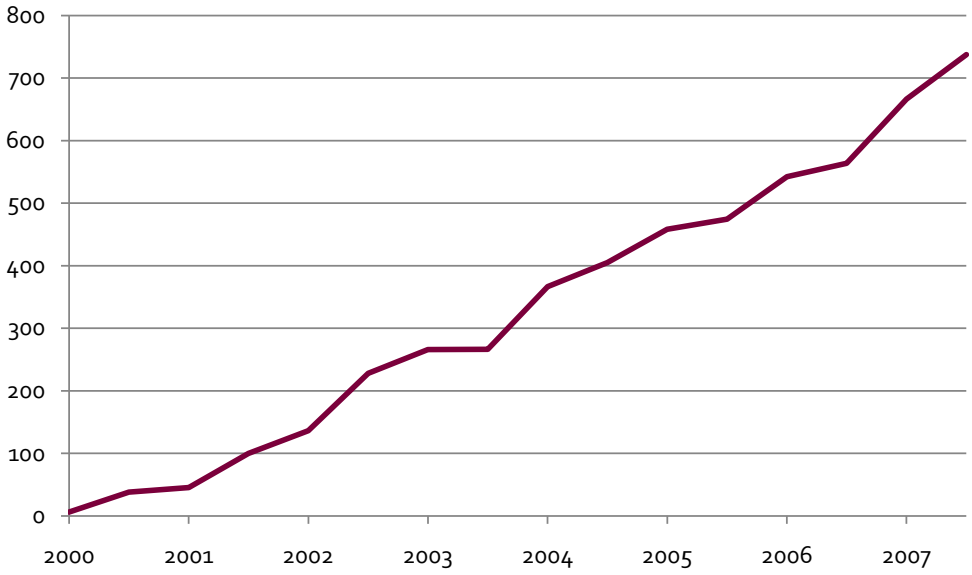
Figure 3: Ratio of risk-weighted assets to unweighted assets falls as financial leverage increases (aggregated for the four largest UK-owned banks)



Source: Financial statements of Barclays, HSBC, Lloyds Banking Group and RBS

2.8 The years immediately preceding the crisis also saw a marked rise in the funding gap[9] between customer deposits and customer loans for major UK banks (see Figure 4). Securitised credit also increased sharply over this period (see Figure 5).

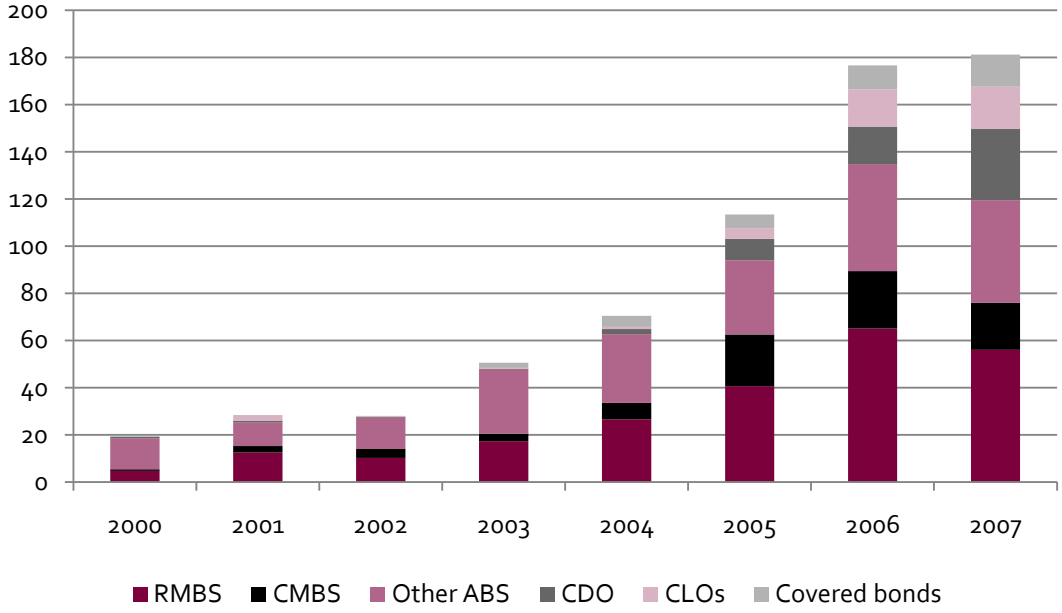
Figure 4: Funding gap (loans less customer deposits) for major UK banks (£bn)



Source: Bank of England

9 Illustrated in Figure A in Annex 1.

Figure 5: Growth of securitisation issuance in the UK (£bn)



Note: See Glossary for an explanation of acronyms.

Source: Oliver Wyman

2.9 It was argued, and widely accepted during the pre-crisis period, that diversifying exposure to credit risk through securitisation made the financial system more stable, not less. Similar claims were made for credit default swaps, the use of which also expanded rapidly over this period. The events of the financial crisis showed the opposite.

2.10 The financial crisis played out against the backdrop of these trends, and numerous accounts have previously been published of the way in which these factors and others contributed to the crisis. The Commission is not intending to produce its own detailed analysis on this; a brief summary of the development of the crisis is set out in Box 1.

The regulatory environment

2.11 The trends described above took place in a light-touch regulatory environment. While minimum capital requirements for banks had been agreed internationally under the Basel Accord, many banks were found to have insufficient capital to survive the crisis. Banks' liquidity buffers were also demonstrated to be inadequate. Furthermore, financial institutions in the shadow banking sector were not subject to the same regulation as banks. Among other things, this allowed banks to move assets and liabilities off-balance sheet, for example into structured investment vehicles (SIVs) which were often created specifically to avoid regulatory requirements, with a resulting loss of transparency on banks' true exposures. The derivatives market was left largely unregulated (although in the UK it was mostly banks – which are regulated – that wrote and held derivatives).

Box 1: The financial crisis

The causes of the financial crisis will be debated for many years to come. But it is generally accepted that important factors that set the scene for the crisis included: global imbalances, loose monetary policy, light-touch regulation, declining underwriting standards, widespread mis-pricing of risk, a vast expansion of banks' balance sheets and rapid growth in securitised assets.

From the summer of 2007 onwards, losses on securities backed by US subprime mortgages led to stress in the financial system. The effect of these losses – exacerbated by uncertainty as to which institutions were holding assets with unrealised losses – caused a generalised withdrawal of liquidity. Interbank lending declined, and banks' ability to raise funds in the repo markets was hit as participants became more worried about the price that collateral would achieve in a forced sale. Central banks around the world injected huge amounts of liquidity into the banking system in attempts to alleviate banks' liquidity problems.

However, similar concerns also affected leveraged institutions in the shadow banking sector (which did not have access to central banks' liquidity facilities), including hedge funds, insurers, securities dealers and SIVs. Having long-term assets funded with short-term borrowings, leveraged institutions were vulnerable to re-financing risk. As the crisis progressed and asset prices fell, these institutions suffered what were effectively runs. Lenders demanded more or better quality collateral against loans. Unable to comply, borrowers were forced to sell assets to repay their loans, further depressing prices. The problem for many financial institutions was compounded by the fact that liquidity provision commitments and reputational concerns led them to bring off-balance sheet vehicles – such as SIVs – back on balance sheet.

The combination of depressed asset prices and increasing losses coming through on loans led to fundamental solvency issues at a number of institutions, both banks and non-banks. In the US, Bear Stearns had to be rescued by JP Morgan (with US Government support) in March 2008 and Lehman Brothers collapsed in September 2008. Unable to meet collateral requirements, AIG was bailed out by the US Government in September 2008. RBS and Lloyds Banking Group were bailed out by the UK Government in October 2008, and there were more government bail-outs in Europe. With falling asset prices, and troubled financial institutions cutting back on lending, the crisis spread beyond the financial sector, and economies around the world were thrown into recession.

Two key themes emerge from the experiences of the last few years. First, the interconnected nature of financial markets and institutions created positive feedback loops, exacerbating the crisis. For example, the failure of one systemically important financial institution could threaten the survival of others; and falls in asset prices forced highly leveraged borrowers to de-leverage through selling assets – triggering further falls in asset prices. In short, component failure threatened system failure. Second, without the intervention of national authorities around the world – requiring taxpayers to incur significant direct costs and larger contingent liabilities – the consequences of the crisis would have been immeasurably worse.

2.12 Countries around the world (including the UK) have responded to the crisis by enacting various regulatory reforms, and there are a number of ongoing initiatives – in particular, further reform of the Basel Accord. There is also a new emphasis on macro-prudential regulation – measures that are intended to improve the stability of the financial system as a whole, including its resilience to cyclical developments, rather than simply looking at the position of individual firms in isolation.

2.13 Financial markets, and many financial institutions, are international in nature. Regulation at national level therefore needs to take account of developments in other countries. In particular, any policy proposal by a national regulator to impose enhanced regulatory standards on financial institutions based in its territory needs to take account of the extent to which institutions may move some or all of their activities to jurisdictions with a different (looser) regulatory regime.[10]

2.14 More information on the initiatives currently under way for the reform of financial regulation and related accounting rules is set out in Annex 2.

10 Also relevant in this context is the potential for any EU regulatory requirements to be subject to "maximum harmonisation", limiting EU countries' ability to impose stricter regulatory standards than those agreed at EU-wide level.

Chapter 3: Issues

3.1 The Commission's terms of reference require it to make recommendations to promote stability and competition in banking, while having regard to "the Government's wider goals of financial stability and creating an efficient, open, robust and diverse banking sector, with specific attention paid to the potential impact of its recommendations on: financial stability; lending to UK consumers and businesses and the pace of economic recovery; consumer choice; the competitiveness of the UK financial and professional services sectors and the wider UK economy; and risks to the fiscal position of the Government".

3.2 This chapter therefore sets out to identify the key issues concerning:

- financial stability; and
- competition in banking (including consumer choice),

while also considering:

- lending and the pace of economic recovery;
- the competitiveness of UK financial services and the wider economy; and
- risks to the Government's fiscal position.

Financial stability

3.3 In considering what "stability" means in this context, it is useful to consider the key ways in which banks and other financial institutions can support the wider economy, namely by:

- providing payment systems;
- providing deposit-taking facilities and a store-of-value system;
- lending to households, businesses and governments; and
- helping households and businesses to manage their risks and their financial needs over time.

3.4 For a financial system to be "stable", it must at a minimum be able to meet demand for these services in a robust way. A key risk to the stability of the system is that a firm will fail, and that this failure will bring the system down. Note that the failure of an individual firm is not a problem in itself, and in most markets the possibility of this occurring is a healthy, competitive spur to efficiency. However, in financial markets, as we have seen, the interconnectedness between institutions means that component failure can lead to system failure.

3.5 Raising constraints on the way firms behave so as to improve their resilience to shocks aims to reduce the likelihood of individual firm failure. Various ongoing reform initiatives – such as the work of the Basel Committee on Banking Supervision (BCBS) – are looking at measures to achieve this through, among other things, increasing minimum capital and liquidity requirements for banks, tightening or introducing leverage ratios, and reviewing the way in which accounting rules require banks to provision for losses. But this does not mean that it would be desirable for the likelihood of firm failure to be reduced to zero. On the contrary, badly managed, uncompetitive firms should face the real prospect of failing. However, one of the most serious issues revealed by the recent crisis has been that of firms that cannot be allowed to fail because of the impact their failure would have on the rest of the system. See Box 2 for a discussion of systemic risk.

3.6 So long as there is a perception that systemically important financial institutions (SIFIs) are "too big to fail",[1] or too interconnected, their management, investors and counterparties are likely to believe that these institutions effectively operate with implicit state support. This constitutes a perceived acceptance of risk by the state (and hence the taxpayer) with the potential for the related rewards[2] to be enjoyed by the private sector (e.g. high levels of remuneration for employees and high levels of profits for shareholders). This is not only inequitable, but also creates moral hazard incentives for poor decision-making – market participants behave differently than they would in the absence of such support, because they know that they are not taking the same risks. This separation of the costs of risk and the benefits of reward produces inefficiencies through the distortion of resource allocation and risk management; it incentivises excessive risk-taking. (Note that SIFIs are not the only source of moral hazard in the financial system. Deposit insurance, short-term remuneration structures and the risk-reward asymmetry associated with the limited liability nature of banks – and indeed other limited liability companies – are all examples of sources of moral hazard.)

1 Note that size alone is not necessarily a good measure of systemic importance. Accordingly the phrase "too big to fail" should be interpreted as shorthand for "too systemically important to fail".
2 The extent to which the private sector reaps such rewards depends in part on the degree to which markets in financial services are competitive.

Box 2: Systemic risk

In most sectors of the economy the failure of one firm does not typically jeopardise its competitors, nor does it cause markets to fail to work. In the financial sector, however, there is a risk that the failure of a major financial institution or market can have adverse effects on the financial system more generally. Such systemic risk can operate through several related channels.

In a classic bank run, depositors lose confidence in a bank and rush to withdraw their deposits. If panic spreads to other banks, the system as a whole may enter crisis. The vulnerability of banks to runs typically arises from maturity transformation – the fact that their assets (e.g. loans to businesses and households) are longer-term than many of their liabilities (notably demand deposits). A bank may be vulnerable to a depositor run even if it is solvent in the sense that its assets would be worth more than its liabilities if held to maturity, but not if liquidated prematurely. So even a solvent bank can face a liquidity crisis, though in practice liquidity problems may reflect doubts about solvency. Deposit insurance and lender-of-last-resort facilities are designed to make bank runs less likely.

Through the interbank market, banks lend each other large sums of money, typically short-term. This is normally an efficient way to economise on liquidity in the system, and to give each bank access to a wider pool of liquidity than it would have in isolation, and hence provide a buffer against liquidity risk. At times of crisis, however, linkages between banks can cause shocks to propagate through the system. If Bank A has provided credit to Bank B, then (fears of) default by Bank B might threaten to bring down Bank A. Such counterparty exposures are one reason why panic can spread among banks. Market uncertainty about which banks have bad assets can cause interbank lending to seize up.

Close parallels to depositor runs can therefore occur in the wholesale markets, as the recent crisis has shown. For example, through higher collateral requirements, liquidity may drain from repo markets, leaving institutions that are reliant on short-term funding unable to refinance their activities. It is not only depositary institutions that are vulnerable to liquidity crises: in 2008 there were, in effect, runs on institutions in the shadow banking sector, notably Bear Stearns and Lehman Brothers.

Quite apart from the issue of counterparty risk, Bank A's liquidity problem can harm other banks by causing Bank A to engage in a "fire sale" of some of its assets. If Bank A is sufficiently large in relation to the markets concerned, that will depress asset prices and hence weaken the balance sheets of other banks. Note that, whereas runs operate on the liability side of the balance sheet, the fire-sale problem starts on the asset side (although marked-to-market losses will feed through to erode equity on the liability side). They are distinct but reinforcing sources of systemic risk.

3.7 So the implicit state guarantee for SIFIs distorts markets inefficiently and unfairly. Yet the events of the last few years have seen this guarantee, and the moral hazard it engenders, strengthened. As a result of consolidation in the financial sector the systemic importance of key institutions has increased, and in the aftermath of the collapse of Lehman Brothers it would strain credibility for a government to claim in advance that it would not rescue an institution whose failure was likely to have severe, systemic consequences. A fundamental question, therefore, is whether the architecture of the financial system can be reformed to contain the impact of the failure of a significant institution.[3]

Competition

3.8 In a well-functioning market, suppliers compete with each other, and with the threat of entry by potential new entrants, to provide a choice of products to well-informed customers. Those who succeed in attracting and retaining customers – by offering cheaper, higher quality and/or innovative products or services – deservedly prosper. Products that are of poor quality or have a higher price than others are forced out of the market, and firms which persist in trying to sell such products ultimately fail. Markets are more competitive when unsuccessful firms face a real possibility of failure.

3.9 It bears emphasis that what matters is not competition *per se*, but competition to provide what customers want. Where markets are not functioning well, suppliers' incentives can be distorted, and competition can be a mixed blessing – suppliers may compete amongst themselves, but not necessarily on issues that customers care about. Examples of possible distortions of incentives in financial services markets are:

- ill-informed (even mis-informed) choice by customers, notably in retail markets (the consequences of which may be exacerbated by the long-term nature of some retail financial products);[4]
- misalignment of incentives between owners, creditors and managers of firms, e.g. because of the last being unduly rewarded on the basis of short-term relative performance measures; and
- misaligned incentives with regard to risk-taking to the extent that owners, creditors and/or managers are shielded from the adverse consequences of risks taken on by firms (e.g. by an implicit state guarantee).

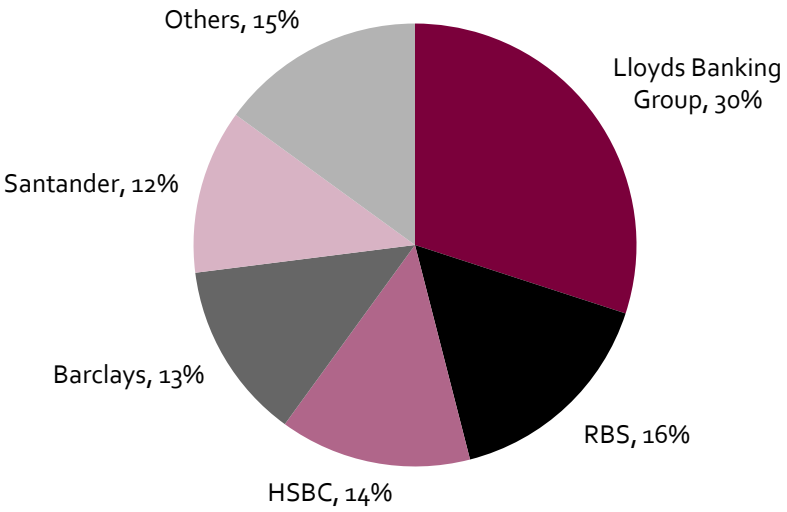
3 The Financial Stability Board is also looking into measures to address the moral hazard risks associated with SIFIs. It is expected to develop a framework of recommendations later this year.
4 For example, a report commissioned by HM Treasury in 2003 into the UK mortgage market concluded that more customers would choose a longer-term fixed rate mortgage, reducing their exposure to interest rate risk, if they were better informed (Miles, D., 2004, *The UK Mortgage Market: Taking a Longer-Term View*, London, HM Treasury).

Regulatory measures – whether structural or behavioural – that address such distortions may be viewed in part as seeking to channel competitive efforts towards efficient ends, and away from undesirable ones. More generally, issues of incentive (mis)alignment are central to considerations of the relationship between financial stability and competition (see Paragraphs 3.17 to 3.23 below).

3.10 There were a number of mergers in the UK financial sector in the run-up to the crisis, and the crisis itself led to further mergers, despite concerns that they might lessen competition.[5] This has the potential to impact on competition in at least two ways: first, by making markets for financial services in the UK more concentrated, potentially increasing the market power of the existing firms; and second, consolidation has entrenched the advantages that SIFIs gain from being "too big to fail". The implicit (if not explicit) support that SIFIs receive from governments provides them with a competitive advantage over those incumbent institutions which are not SIFIs,[6] and also has the effect of raising barriers to entry. Both of these can reduce competition.

3.11 Markets for financial services in the UK are typically quite concentrated. Figures 6, 7 and 8 illustrate the shares of the top five banking groups in the markets for each of personal current accounts, residential mortgages and SME banking.

Figure 6: Market shares for UK personal current accounts

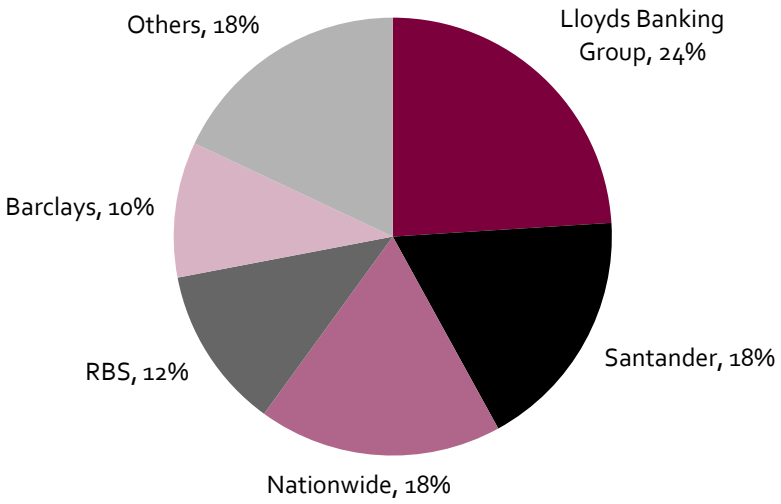


Note: Market share measured by number of customers (2010).

Source: Mintel

5 The Office of Fair Trading published its advice on the Lloyds TSB/HBOS merger on 31 October, 2008. It said that "there is a realistic prospect that the anticipated merger will result in a substantial lessening of competition in relation to personal current accounts (PCAs), banking services for SMEs and mortgages." See http://www.oft.gov.uk/shared_oft/press_release_attachments/LLloydstsb.pdf for more information.
6 For example, through reduced funding costs. See speech by Andrew Haldane, *The $100 billion question*: http://www.bankofengland.co.uk/publications/speeches/2010/speech433.pdf.

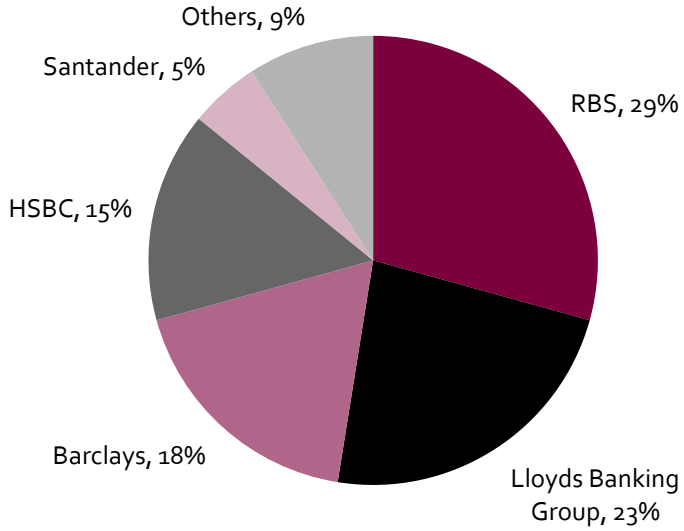
Figure 7: Market shares for UK residential mortgages



Note: Market share measured by gross lending in 2009.

Source: Council of Mortgage Lenders

Figure 8: Market shares for UK SME banking services



Note: Market share measured by number of customers, taking account of Lloyds TSB/HBOS merger but not accounting for recently agreed sale of 318 RBS branches to Santander (2008).

Source: Mintel

3.12 The degree of concentration in a market – for example, as measured by the market shares of the largest firms – is not always a reliable indicator of the degree of competition. Competition can be strong in quite concentrated markets and weak in markets that are not highly concentrated. There is nevertheless a tendency, all else equal, for markets to be less competitive when more concentrated.

3.13 The personal current account market is the cornerstone of the UK's retail finance system. It is of particular importance given its role in payment systems and since many consumers purchase other financial products from their personal current account provider. The Office of Fair Trading (OFT) published a report into personal current accounts in 2008, in which it found some evidence of competition in that market but nevertheless concluded that it was not working well for consumers. The report identified three particular problems in the market:

- complexity and lack of control over unarranged overdraft charges;
- low levels of transparency of charges and other costs; and
- problems with switching providers.

The OFT found that consumers and competition were focused almost exclusively on more visible fees such as ATM charges, and not on less visible elements such as "insufficient funds" charges. The OFT also raised concerns: about cross-subsidies from low income to higher income consumers; that the scale of cross-subsidisation appeared to be very significant; and that lack of competition may have led to reduced innovation.

3.14 These problems are not necessarily a consequence of the structure of the industry. In order for markets to work effectively, consumers need to have the relevant information on what products are being offered, and be able to compare products and switch suppliers easily. These conditions for informed consumer choice do not always hold for retail financial services products.

3.15 In addition to the OFT's study into personal current accounts in 2008,[7] a range of investigations has been conducted over the last ten years (or are ongoing) into competition in markets for financial services, including those in Box 3. The Commission will take due account of the findings of these investigations, including those, such as the OFT's review of barriers to entry in retail banking, which are currently under way.

7 Since 2008 the OFT has carried out follow-up work on personal current accounts; further information is available here: http://www.oft.gov.uk/OFTwork/markets-work/completed/personal/.

Box 3: Investigations into competition in markets for financial services[8]

UK Authorities

- Competition in the UK banking industry (Cruickshank report, 2000)
- Lloyds TSB and Abbey National proposed merger (Competition Commission (CC), 2001)
- SME banking (CC, 2002)
- Payment services – market study of clearing systems and review of plastic card networks (OFT, 2003)
- Debt consolidation (OFT, 2004)
- Credit card default charges (OFT, 2006)
- Northern Ireland banks market investigation (OFT, 2005; CC, 2007)
- Proposed acquisitions of London Stock Exchange (OFT, 2005-7; CC, 2005)
- Payment Protection Insurance (OFT, 2005; OFT, 2006; CC, 2009)
- Home credit (OFT, 2004; CC, 2006)
- Store card credit services (OFT, 2004; CC, 2006)
- SME banking (OFT, 2007)
- Lloyds TSB/HBOS merger (OFT, 2008)
- Credit card comparisons (OFT, 2008)
- Payments Council (OFT, 2009)
- Barclays/RBS sharing price information in commercial banking (OFT, 2010)
- Cash ISAs (OFT, 2010)
- Interchange fees (OFT, commenced 2000)
- Review of barriers to entry, expansion and exit in retail banking (OFT, commenced 2010)
- Equity underwriting (OFT, commenced 2010)
- Inquiry into competition and choice in the banking sector (Treasury Select Committee, commenced 2010)

European Authorities

- Inquiry into retail banking (European Commission, 2007)
- Interchange fees (European Commission, ongoing)
- Numerous other European Commission investigations, including into mergers and State Aid on an institution-specific basis

8 Dates given are for publication of report.

3.16 Assessing levels of competition in wholesale & investment banking markets is complicated by the fact that there has been much less analysis of these markets and they can be significantly more cross-border in nature. It is therefore useful to consider market shares at a global level, as well as at a national level. Tables 1 and 2 show UK and global market shares of fee revenues for the ten largest firms in investment banking services.

Table 1: Share of fees in UK market (2009)

	Bank	UK market
1.	JPMorgan	12.1%
2.	RBS	8.8%
3.	UBS	6.7%
4.	Goldman Sachs	6.5%
5.	Citi	6.0%
6.	Credit Suisse	5.6%
7.	Barclays Capital	5.5%
8.	Bank of America Merrill Lynch	4.9%
9.	HSBC	4.8%
10.	Morgan Stanley	4.7%

Table 2: Share of fees in global market (2009)

	Bank	Global market
1.	JPMorgan	9.0%
2.	Bank of America Merrill Lynch	6.8%
3.	Goldman Sachs	6.8%
4.	Morgan Stanley	6.0%
5.	Citi	5.6%
6.	Credit Suisse	5.0%
7.	Deutsche Bank	4.6%
8.	UBS	4.6%
9.	Barclays Capital	3.3%
10.	RBS	2.6%

Note: Market share of fee revenues from the provision of investment banking services in debt capital markets, equity capital markets, syndicated lending and mergers & acquisitions. The "UK market" covers transactions for which the client (or its ultimate parent, if relevant) is UK-based.

Source: Dealogic

Interaction of financial stability and competition

3.17 There are arguments that competition between banks can be bad for stability. One such argument is that competition, by reducing profitability, encourages greater risk-taking, to the detriment of stability. According to this view, the higher prospective profits that come with market power may reduce the moral hazard problem of banks taking on excessive risk because they keep the upside if risks go well but are not exposed to all the downside losses. Higher profits not only help banks to maintain better capital cushions, but they also mean that banks' investors have more to lose if risks go badly, thereby incentivising them to discipline risk-taking. Better capital cushions might also increase depositor confidence and so reduce the risk of runs. It is not clear, however, that allowing banks market power (for which the rest of the economy has to pay) is a good way of ensuring that there is adequate bank capital and liquidity to guard against excessive risk-taking or losses of confidence.

3.18 A second line of argument is that banks (and their key staff) compete to impress investors as well as in markets for banking services. Arguably, such competition compels banks to pursue aggressive strategies in the hope of achieving good-looking short-term results; such strategies entail banks running (less visible) longer-term risks and so have a deleterious impact on financial stability.

3.19 A further argument says that more competition may diminish the incentives of banks to invest in monitoring the credit risk of borrowers, as borrowers are more likely to switch their business between banks. This could have adverse consequences for financial stability. (Although the contrary argument can also be made – that it is in less competitive markets that banks' incentives to invest in relationships with borrowers are reduced, as borrowers are in any case less likely to move to another provider.)

3.20 On the other hand, there are arguments that weak competition in banking can be bad for financial stability (as well as for consumers of financial services). First, banks may be more likely to be systemically important in a market with fewer rivals, exacerbating the "too big to fail" problem. Second, if business customers are offered worse borrowing terms when competition is weak, they might be induced to follow riskier business strategies – which have the potential to produce greater returns – than if loans were on competitive terms, with the result that bank risk is greater. Third, the exercise of market power by banks might drive some financial activity into non-bank channels, which will be less (if at all) regulated, and might create more systemic risk. And fourth, competition between banks may have the effect of increasing efficiency, including risk management capabilities, in the sector, so enhancing financial stability.

3.21 As to the effects of financial (in)stability on competition, it has already been noted how the financial crisis has led to the disappearance of independent competitors as they have left the market or been acquired by others. Persistence of the problem of some banks being "too big to fail" would distort competition in the future as those banks would have an unmerited competitive advantage over others. Thus acquiring the aura of being "too big to fail" could itself become a commercial objective.

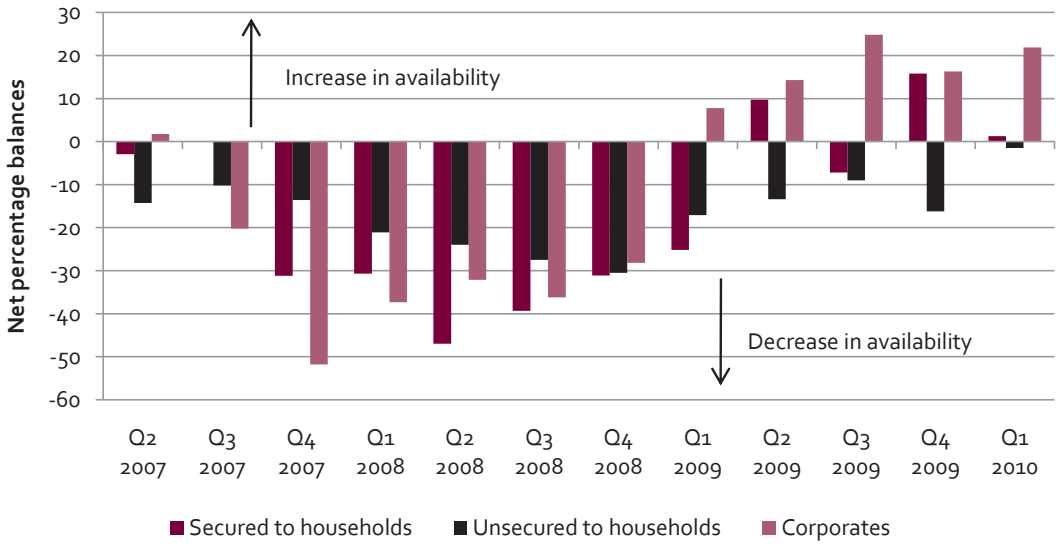
3.22 It is finally worth noting that policy measures aimed at improving stability can impact on competition. For example, poorly-designed capital and liquidity regulations could distort competition between business models, and the very fact of banking being a regulated industry raises barriers to entry. On the other hand, reforms (e.g. to market infrastructure) to ameliorate problems of asymmetric information in financial markets have the potential to be positive for both competition and stability. In addition, there is the potential for resolution schemes (as discussed in Paragraph 4.22 below) to have a positive impact on competition by reducing barriers to exit.

3.23 In sum, there appear to be various and mixed effects of competition on financial stability, and vice-versa, and no strong grounds to say that there is some clear trade-off such that more of one means less (or more) of the other. The issues are complex, and call for closer analysis.

Lending and the pace of economic recovery

3.24 The UK banking sector makes a key contribution to the wider economy through the provision of credit to households and businesses. The financial crisis led to a reduction in the availability of credit (see Figure 9), and produced a sharp decline in UK GDP.

Figure 9: Household and corporate credit availability



Note: Net percentage balances are calculated by weighting (using a lender's market share) together the responses of those lenders who answered the question as to how the availability of credit provided to the sector overall changed in the past three months.

Source: Bank of England Credit Conditions Survey

Well-functioning, sustainable credit markets are essential to the economic recovery. In making its recommendations, the Commission will pay careful attention to their likely impact on the availability and cost of credit, and the likely consequences for economic growth.

Competitiveness of UK financial services and the wider economy

3.25 The UK is a major exporter of financial services; banking sector net exports alone grew from around £11bn to around £30bn from 2003 to 2008.[9] London's position as a global financial centre is reflected in the presence of the full range of financial activities. In making its recommendations, the Commission will need to consider how it might influence the attractiveness of the UK as a place in which to conduct banking activities and other financial services (including the extent to which this may be enhanced by having a robust, stable, well-regulated financial sector). Also, there are likely to be strong connections between London's financial sector and the UK's strong position in related business and professional services.

3.26 The Commission will also have regard to the likely impact of its recommendations on the competitiveness of the wider UK economy. One of the factors to be considered here will be the extent to which having a stable and competitive banking sector may enhance the attractiveness of the UK as a place in which to conduct non-financial sector business, and be good for the economy as a whole.

Risks to the Government's fiscal position

3.27 Depending on its stability, the banking system directly benefits the Government's fiscal position through providing tax revenue. In 2007 the banking sector accounted for approximately 4.9% of UK GVA, with the broader financial sector accounting for around 8.3%.[10] However, for the financial year 2007/8 the financial sector accounted for approximately 14% of PAYE revenue[11] and 27% of corporation tax receipts.[12] (Of course, these figures should be set in the context of the increase in banks' balance sheets that were a cause of the financial crisis.)

3.28 The potential for direct costs to the Government from financial sector instability has been demonstrated by the recent crisis. Support for the financial sector provided by the Government has required taxpayers to incur large direct expenditures and assume

9 Office for National Statistics (ONS) Pink Book 2010: http://www.statistics.gov.uk/statbase/product.asp?vlnk=1140.
10 ONS Blue Book 2010: http://www.statistics.gov.uk/downloads/theme_economy/bluebook2010.pdf. GVA (gross value added) = GDP – taxes on products + subsidies on products. Note, however, that there are particular difficulties in measuring the economic value of financial services.
11 http://www.hmrc.gov.uk/stats/income_tax/table2-10.pdf.
12 http://www.hmrc.gov.uk/stats/corporate_tax/table11-5.pdf.

even larger contingent liabilities. The expenditures have included capital injections into a number of financial institutions, most notably RBS and Lloyds Banking Group, in which the Government continues to hold significant shareholdings. As long as banks require support via public interventions of this kind, the public purse remains exposed.

3.29 The banking sector also has an indirect – and far greater – impact on the Government's fiscal position through the effect that the sector (and the wider financial sector) has on economic growth. A robust banking sector that efficiently allocates capital around the economy will be beneficial for growth and hence tax revenues. We have witnessed the opposite of this in recent years, as crisis spread from the financial sector to the wider economy.

Chapter 4: Options for reform

General considerations

4.1 The purpose of this chapter is to describe a (non-exhaustive) range of possible reform options, together with some of their pros and cons, which will need to be analysed as the Commission's work progresses. The Commission intends to publish in the Spring a much more detailed analysis of what it then judges to be the leading reform options within the scope of its remit. However, it is worth repeating that at this early stage, the Commission has not moved towards any particular options for reform.

4.2 The reform options outlined below distinguish between those that relate to the structure of banks and those that relate to the structure of markets. The Commission's remit calls for recommendations covering "related non-structural", as well as "structural", measures to promote stability and competition in the banking system. There is not a clear dividing line between the two categories, nor between them and other non-structural measures. Moreover, policies not expressly designed to have a significant structural impact could nevertheless have structural consequences if they affect banks' own choices about their structures.

4.3 In this context it is worth noting a general point about the relationship between the regulation of structure and the regulation of behaviour. In theory, ideal behavioural regulation could entirely correct undesirable private incentives, making structural regulation unnecessary. In practice, however, there are circumstances where structural rules solve the problem more effectively, and in the process save on the need for behavioural regulation. For example, in some utility industries there is the concern that a network monopolist that also conducts a downstream activity might deny network access on fair terms to rivals in that downstream activity. Structural separation between the network and the downstream activity can deal relatively simply with the problem and avoid the (direct and indirect) costs of behavioural regulation, albeit at some cost if there are economies of scope between the two activities. In banking, where a central concern is that deposit-taking institutions may take on too much risk, a purely non-structural approach might continually adjust capital and liquidity requirements to the banks' risk decisions, whereas a structural rule might simply prohibit the combination of deposit-taking and the taking of certain kinds of risk. The general question is what mix of structural rules and regulation of behaviour works best.

4.4 The Commission's analytical attention will therefore extend beyond structural and related non-structural reform options because their desirability and effectiveness will depend in part on other reform initiatives, for example concerning capital and

liquidity regulation (to the extent unrelated to structure, on which see Paragraph 4.25 below). Conversely, some structural measures might have the potential to ease the burden of conduct regulation.

4.5 The Commission will also pay close attention to the shadow banking sector, where non-bank institutions carry out banking activities. The effect of reforms for the banking sector would obviously be significantly diminished if the problems they sought to address simply migrated across to the shadow banking sector.

4.6 Furthermore, the Commission will have careful regard to the international dimension, including ongoing international regulatory reform initiatives, the foreign operations of UK-owned banks, and the role of foreign-owned banks that operate in the UK. This last will include a consideration of the role of foreign-owned banks which operate in the UK through branches and therefore continue to be regulated primarily by the relevant foreign regulator, rather than through subsidiaries, which are regulated in the UK in the same way as UK-owned banks. Any bank that is authorised in a country within the European Economic Area (EEA) is entitled to do banking business in other EEA countries through a branch or by providing services directly, e.g. internet banking.[1]

Reform options related to the structure of banks

Separation of retail and investment banking

4.7 One of the issues that the Commission has been specifically asked to consider is "the complex issue of separating retail and investment banking". A functional separation of that kind existed in the United States under the Glass-Steagall Act from 1933 until its eventual repeal in 1999 (although the restrictions of the Glass-Steagall Act had been watered down before then). Under the Act, the same entity could not combine commercial banking, in particular deposit-taking, and certain investment banking activities such as issuing, underwriting and trading in securities.[2]

4.8 The main rationale for functional separation along these lines is that it reduces the chance that inherently risky investment banking activities will put depositary institutions in (actual or perceived) jeopardy. A related advantage is that investment banking decisions then have to be made without the backing of publicly insured deposits from retail banking activities. Thus, the argument goes, functional separation promotes financial stability. Further rationales are that separation guards against conflicts of interest – for example, that a bank could profit in its securities trading from

1 So a bank from outside the EEA could incorporate a subsidiary in a country within the EEA, and that subsidiary would then be entitled to do business elsewhere in the EEA.
2 Note that the Glass-Steagall Act did not seek to separate off all wholesale & investment banking activities from deposit-taking. Activities such as wholesale lending – which are an important part of the activities of universal banks in the UK – would not be required to be separated from deposit-taking by a Glass-Steagall type rule.

inside information from its commercial banking business – and against the possibility that integration might present barriers to entry and growth of competitors.

4.9 The broad arguments against separating retail and investment banking are claims that it is undesirable and/or ineffective. For example, it might be more efficient in terms of banks' or customers' costs for "universal" rather than separated banking services to be provided. Formal separation might be unworkable in the complex commercial reality of modern financial markets, and do little of practical value if regulatory arbitrage can undo its economic effects (for example, if a branch of a foreign-owned bank operating in the UK was able to collect retail deposits in the UK and use them to fund investment banking activities).

4.10 Some have contended that, besides such practical difficulties, separation on the lines of Glass-Steagall would have done little or nothing to prevent the recent crisis or to diminish its impact, bearing in mind that the impact of the crisis was not limited to banks operating universal banking business models. This argument has been extended to claim that universal banks, through diversifying their range of business activities and hence their exposure to risk, can actually be more stable than separate retail and investment banking businesses.

Narrow banking and limited purpose banking

4.11 Proponents of "narrow banking"[3] or of "limited purpose banking"[4] would go further than Glass-Steagall. Under narrow banking, retail deposits are 100% backed by safe, liquid assets, of which government bonds of short-to-medium maturity are the prime example. Retail deposits would have public deposit insurance, but the government would not bail out any other banking activity (though a narrow bank might be allowed to be part of a larger bank holding company). The core "utility" services of banking – transaction services and retail deposit-taking – would thereby be isolated from risky activities undertaken by banks, decisions about which would therefore not be distorted by considerations of moral hazard arising from implicit state support.

4.12 The narrow banking proposal is open to several challenges. First, there is an economic cost to the extent that there are synergies between deposit-taking and bank lending activities, which would be lost under narrow banking. Second, narrow banking entails tying up banking deposits in government bonds, rather than allowing them to be made available to fund productive investment through financial intermediation. A related point is that there would appear not to be enough UK Government bonds available to back retail deposits. While the total volume of UK Government bonds in issue is comparable in size to total UK retail deposits, there are significant demands

3 E.g. Kay, J., 2009, *Narrow Banking: The Reform of Banking Regulation,* Centre for the Study of Financial Innovation.
4 E.g. Kotlikoff, L., 2010, *Jimmy Stewart is Dead,* Hoboken, John Wiley & Sons Inc.

for these bonds from financial institutions such as pension funds.[5] Third, and in view of policy responses in the recent crisis, narrow banking might not, in any case, stop governments bailing out other banking activities – e.g. lending to SMEs and households – if they got into trouble.

4.13 The answer under limited purpose banking is that all financial intermediation is conducted by mutual funds (of which cash mutual funds would be a special case, essentially replacing personal current accounts) that issue shares. Being thereby securitised, all lending has 100% equity backing – i.e. from the owners of the shares in the mutual funds. This scheme is open to some of the same criticisms as narrow banking. There would be a reduction in the economic value added from intermediation. Bank loans – normally regarded as illiquid assets prone to major problems of asymmetric information – would be packaged into mutual fund units held directly by households. These units would be less liquid than traditional bank deposits, so households choosing to participate in funds that invest in loans – as opposed to in cash mutual funds – would be likely to experience a reduction in the overall liquidity of their assets.

Limits on proprietary trading and investing

4.14 A less radical option, which has to some degree been incorporated in the recent US legislation for regulatory reform (the Dodd-Frank Act), is the so-called Volcker Rule, which restricts the proprietary trading and investing activities of deposit-taking institutions, including their participation in hedge funds and private equity business. Unlike Glass-Steagall, this proposal allows retail banking to be combined with investment banking activities that do not entail proprietary trading. Its motivation is to remove own-account risk-taking from depositary institutions and thereby promote financial stability, and to reduce risk-taking by institutions that are eligible for government support.

4.15 Whatever its merits in principle, there is the practical question of how to tell the difference between proprietary trading on the one hand, and risk-reducing hedging or market-making on the other. For example, a bank might acquire a large position in interest rate swaps for speculative reasons or, by contrast, to hedge interest rate risk naturally arising from the maturity transformation of ordinary commercial banking business.

What degree of separation?

4.16 Restrictions on the activities that banks may combine could be implemented in various ways, ranging from having separately owned entities to forms of "internal"

5 Although we cannot assume that there would be the same demand for retail deposits under narrow banking as there is now: all other things being equal, narrow banks would presumably pay less interest on retail deposits than commercial/universal banks, making retail deposits less attractive for customers.

separation within a corporate group. However, as recent experience with the (unregulated) off-balance sheet entities of some banks shows, formal boundaries are vulnerable to being over-ridden at times of crisis. Thus in considering the possibilities below, it should not be assumed that formal internal separation necessarily means real separation.

4.17 The most complete form of separation would require the different activities to be carried out by entirely separate companies with no affiliations, and would prohibit banks from sponsoring any entities (regardless of the nature of the activities they conduct) that are not fully consolidated for regulatory and accounting purposes.

4.18 Another possibility would be to allow separately capitalised and regulated subsidiaries with a common holding company to perform different activities. The holding company would issue equity and use the proceeds to capitalise its subsidiaries, but would not otherwise undertake any business activities.[6] Any dealings between the subsidiaries would be on an arm's length basis. This model aims to limit risk exposure and the potential for contagion across business lines. It also facilitates structural separability (see below), offering more options for resolution in the event of failure. Yet it might allow some cost synergies to be exploited.

4.19 Such an organisational reform could be complemented by separate reporting requirements between subsidiaries (enhancing transparency and hence market discipline) and by strengthened regulation which could be more accurately tailored for specific activities undertaken by different subsidiaries. While a multi-subsidiary model might reduce the likelihood of companies being systemically important, appropriate measures would still need to be put in place to deal with any subsidiaries which were systemically important in their own right.

4.20 A key question is whether such subsidiaries would be truly separate, and not prone to the sort of issues experienced with SIVs in the recent crisis, where reputational and/or legal concerns led to financial institutions (and in some cases the public purse) being liable for the losses of such off-balance sheet vehicles. There is also the related question of whether banks should be permitted, from a regulatory and/or accounting perspective, to continue to sponsor off-balance sheet vehicles at all, bearing in mind the events of the recent crisis.

Structural separability

4.21 Short of structural separation *ex ante*, a related set of reform options would require that the operations of a systemically important (or other) bank should be readily separable if circumstances require. For example, a bank might be allowed to combine investment banking with retail banking in "normal" times so long as there was a clear mechanism for their separation if the investment banking arm got into difficulty.

6 Some centralised group functions could be located at the holding company level.

Then, in extreme circumstances, the latter could be liquidated efficiently and at no public expense while preserving the retail activities uninfected by bad investment banking assets.

4.22 The general idea of such schemes is to have the advantages of separation if a crisis occurs, while not requiring it from the outset. Further, the contingent prospect of separation should in theory deter undue risk-taking in the first place. A major challenge for such schemes, however, which cross-border considerations heighten significantly, is practicability. Two broad and complementary approaches are:

- "living wills", whereby banks are required to commit to detailed plans specifying what would happen to their assets and operations in the event of crisis; and

- resolution schemes, whereby public authorities take temporary control of (at least some) assets and operations in those circumstances.

4.23 Putting a living will or a resolution scheme into action may well involve implementing structural functional separations of the sort discussed above. A related point on resolution concerns the ranking in priority of a firm's various creditors. One option, which would reduce the probability of pay-out under state-backed deposit insurance and the related moral hazard, would be to alter the priority of claims in the insolvency of a bank so that retail depositors ranked ahead of all, or some, other unsecured creditors.

Contingent capital

4.24 In a similar spirit to living wills and resolution schemes are proposals under which the capital structures of banks would automatically switch if a critical point was reached. Convertible debt could provide one such form of contingent capital. If a predefined threshold (e.g. in terms of capital ratios) was crossed, the debt would convert, in full or in part, to equity or preferred stock.[7] Alternatively, the regulatory authority could have powers (within certain parameters) to determine the point of conversion – sometimes referred to as "bail-in".[8] Contingent capital schemes go some way to addressing the points that, without pre-commitment, shareholders may have weak incentives to raise additional equity at times of crisis (because debt-holders get much of the benefit – the "debt overhang" problem), and discretionary equity issuance tends to be plagued by problems of asymmetric information at such times. Moreover, corporate tax systems generally give equity finance less favourable tax treatment than debt finance, which encourages leverage. However, poorly-designed contingent capital schemes could themselves heighten risk – for example by adding to downward pressure on asset prices at times of crisis. One structure-related reform option is to require institutions

7 An example of convertible contingent capital is that issued by Lloyds Banking Group in 2009. Convertible debt is illustrated in Figure A in Annex 1.
8 Note that bail-in is not limited to debt that is convertible under the terms of its contract; it could be applied across the liability structure.

whose size or structure makes them systemically important to have a certain proportion of contingent capital.

Structure-related surcharges

4.25 Likewise surcharges – in the form of higher capital and liquidity requirements or taxes – could apply to banks depending on their size and structure. Imposing higher capital requirements, say, on institutions that pose greater systemic risk increases loss-absorbing capacity where it is most needed.[9] Structure-related surcharges may also alleviate the distortions to risk-taking incentives and to competition that arise if SIFIs have implicit state guarantees that other banks do not. Further, they may create incentives for banks to adopt structures that pose lower systemic risk. However, the design and calibration of structure-related surcharges could give rise to serious practical problems, and it is an open question whether they would be superior to more direct structural measures.

Reform options related to the structure of markets

4.26 This section moves on from questions about the structure of banks to questions about the structure of the markets in which they operate. The "structure" of a market is often taken to refer to the number and relative sizes of the firms in it. Thus a concentrated structure is one where supply largely comes from a few firms. As explained in Chapter 2, the financial crisis has tended to increase the degree of concentration in markets for banking services. The term "structure" may also be used to refer to the way that a market is organised – how trading occurs. Both senses of the term are considered in what follows.

Measures to reduce market concentration

4.27 Increases in concentration resulting from mergers are addressed by merger law.[10] This applies to banking as to other sectors of the economy with the exception that, following legislative amendment in October 2008, "the stability of the UK financial system" has become one of very few grounds on which the Secretary of State for Business can intervene in the normal operation of merger law, which is focussed on competition. This amendment was effected so that the Lloyds TSB/HBOS merger could proceed without delay. In principle, the intervention power could, however, be used in future to block a merger on financial stability grounds even where the competition authorities did not believe the merger would substantially lessen competition. Such intervention could even be made non-discretionary: the Dodd-Frank Act prohibits mergers that would result in a bank having more than 10% of the

9 The BCBS is currently considering this issue.
10 In Part 3 of the Enterprise Act 2002 in the UK, and in the European Community Merger Regulation at EU level.

total liabilities of the US banking system (although it allows organic growth beyond the 10% threshold). But it may be unlikely that a merger would be threatening to financial stability – perhaps by creating an entity that would be "too big to fail" – without also being threatening to competition and therefore caught by normal merger law.

4.28 Merger law prevents merger-created increases in concentration that are expected to lessen competition but does not itself reduce concentration (except when requiring divestitures of assets when a merger found to be anti-competitive has already taken place). Some divestitures of bank assets (e.g. branches) in the UK are, however, being required by the European Commission to meet conditions for the approval of public support to banks under EU Treaty provisions on state aid.

4.29 Such divestitures could, in principle, go further. In particular, the Government's ownership stakes in RBS, Lloyds Banking Group and other banks may provide a means for pro-competitive restructuring, although any such measures may have fiscal implications for the Government and might involve significant legal issues. Beyond that, and most radically, is the option of requiring the UK's largest banks to divest assets with a view to creating a more competitive market structure.[11] A related option would be to impose a limit on the size of a bank's overall operations, e.g. by limiting the maximum size of a bank's balance sheet to no more than a certain percentage of GDP.

4.30 A less direct policy option is intervention to reduce barriers to entry and growth by rivals to the largest banks, for example through enhanced current account portability and increased access to payment systems infrastructure, aimed at addressing some of the competition issues identified in Paragraph 3.13 above.

4.31 In addition to measures to reduce market concentration, there is the broader question of the extent to which regulatory authorities should have an ongoing duty to promote competition. The Financial Services Authority (FSA) is currently required under the Financial Services and Markets Act 2000 simply to *have regard to* the need to minimise the adverse effects on competition that may arise from anything done in the discharge of its functions, and to the desirability of facilitating competition between those who are subject to any form of regulation by the FSA. The Government is currently consulting on the extent to which the financial regulator should continue to have regard to these (and other) issues.[12]

11 Such policies have rarely been used in the UK, although one example is provided by the recent break-up of BAA following the reference to the Competition Commission of the supply of airport services in the UK.
12 HM Treasury, 2010, *A new approach to financial regulation: judgement, focus and stability*: http://www.hm-treasury.gov.uk/d/consult_financial_regulation_condoc.pdf.

Market infrastructure reform

4.32 Reform to market infrastructure – such as processes by which financial securities are traded – can affect both financial stability and competition. For example, encouraging securities to be traded through a central counterparty (CCP),[13] rather than bilaterally "over-the-counter" (OTC), may significantly alter the scale of counterparty exposures in the system and hence the nature of counterparty risk.[14] In particular, by netting off trades with each institution, a CCP has the potential substantially to reduce counterparty exposures (although with multiple CCPs this need not happen). A CCP also acts as a firewall between counterparties, isolating the effects of the failure of a market participant. Depending on the design of trading processes, replacing OTC by CCP trading can also change information conditions. For example, market transparency might improve, helping regulation and reducing opportunities for major banks to profit from asymmetric information.[15] However, measures are then required to guard against risks that CCPs do not themselves become sources of financial instability or bottlenecks with undue market power.[16]

Other reform initiatives

4.33 As well as the options outlined above, various other reform initiatives are under way in the UK and internationally, for example on:

- general[17] capital and liquidity requirements on banks;
- taxation of banks;
- shape of regulatory institutions;
- macro-prudential regulation;
- accounting rules for financial institutions;
- financial product regulation;
- regulation of pay structures;

13 As the Dodd-Frank Act does for swaps.
14 The European Commission has recently published proposals on central clearing for OTC derivatives trades.
15 Increased use of exchanges may also improve information conditions. This links in to work by the IMF and the FSB on data gaps in financial markets: http://www.imf.org/external/pubs/ft/fandd/2010/09/burgi.htm.
16 Note that there are specific requirements on the OFT under the Financial Services and Markets Act 2000 to consider competition issues when assessing an application for recognition as a clearing house or investment exchange.
17 General as distinct from structure-related: see Paragraph 4.25 above.

- deposit insurance; and
- corporate governance.

4.34 For the time being the Commission is inclined to see these other reform initiatives as outside the domain of the "structural and related non-structural" measures on which it has been asked to make recommendations. This view may change in due course, and the Commission recognises that "related non-structural" is an elastic term. However, the Commission's analysis will take these and other non-structural developments fully into account, because they are likely to have a direct bearing on the merits of the reform options on which the Commission will consider making recommendations.

Glossary

ABS
Asset-backed security; a security that is backed by cash flows from a pool of underlying assets, such as loans or leases.

Basel Accord
Agreement first reached in 1988 by central banks from twelve countries, including the UK and the US, to establish consistency in international capital standards. Subsequent amendments (Basel II) were published in 2004 but have yet to be fully implemented (in particular in the US). Work is currently in train on further reforms.

Bond
Essentially, a loan that can be traded as an asset in itself. Governments, companies and others issue bonds to raise money; in doing so, they incur an obligation to repay the bondholder in accordance with the terms of the bond, which will typically provide for repayment of principal after a certain period of time, and payment of interest while the bond is outstanding. Once issued, bonds – including the right to receive repayments of principal and payments of interest – can be traded on established markets.

Building society
A building society is a legal entity which instead of being owned by external shareholders (like a company) is a mutual society owned by its members – its savers and borrowers. Building societies undertake similar activities to those of retail & commercial banks. However, their business model has (in part because of statutory restrictions) tended to be more conservative, consisting principally of taking in retail deposits and making loans in the residential mortgage market. One consequence of building societies being owned by their members rather than by external shareholders is that building societies are not able to boost their capital positions by issuing fully loss-absorbing capital instruments (comparable to banks' common equity) to external investors.

Capital
A bank's capital is the amount by which the value of its assets exceeds the value of its liabilities (and so is equal to the equity interest of the shareholders). The capital/asset ratio is a measure of a bank's financial health.

CDO
Collateralised debt obligation; ABS for which the underlying assets are debt instruments (which can include other ABS).

CLO
Collateralised loan obligation; ABS for which the underlying assets are typically corporate or leveraged loans.

CMBS
Commercial mortgage-backed securities; ABS for which the underlying assets are loans secured on commercial property.

Collateral
Property provided by a borrower to a lender to provide protection against the borrower defaulting on a loan. If the borrower does default, the lender has recourse to the collateral.

Counterparty
A person who is a party to a contract.

Covered bond
Debt securities backed by cashflows from underlying assets, often residential mortgages. However, unlike a securitisation, where a covered bond is backed by a pool of bank assets, the bond is an obligation of the bank, and the underlying assets remain on the bank's balance sheet.

Credit default swap (CDS)
A credit default swap (CDS) is a financial contract under which one party sells protection to another party against the occurrence of a defined "credit event" – including restructuring and default – in respect of a specified reference entity. The CDS buyer pays a premium to receive protection against default by the reference entity; the CDS seller receives the premium and in return guarantees the credit risk of the reference entity. If a party holds a security issued by the reference entity, it may want to protect itself against default by the reference entity on that security by entering into a CDS to buy credit protection. Alternatively, a party may simply choose to speculate on the performance of the reference entity by buying or selling a CDS without having any other exposure to the reference entity.

Equity
The shareholders' interests in a company, equal in value to the net assets of the company. It is through their equity holdings that shareholders are entitled to the company's profits (in the form of dividends) and a measure of control over the running of the company (through shareholder voting rights).

Financial intermediation
The activity of channelling funds from lenders (savers) to borrowers by intermediating between them.

Funding
The financing of a bank's operations. Most funding for retail & commercial banking activities is usually provided by customer deposits. Where a bank has a funding gap – where the deposits it has taken in fall short of the amount of funding it requires to finance its loans – it will typically meet this through borrowing in the wholesale funding markets, using, for example, interbank lending and repos. Wholesale & investment banking activities are typically wholesale funded.

Hedge fund
An investment fund (often organised as a private partnership) that has few restrictions on the nature of its investments and transactions. Accordingly, a hedge fund enjoys significant latitude in the investment techniques (such as the use of derivatives and short positions) and broader aspects of its business model (such as charging structure and investment lock-in periods) that it can employ in attempts to manage risk so as to generate profits.

Leverage
Broadly speaking, the ratio of debt to equity. In banking, often refers to the ratio of assets to equity, or of capital to assets.

Liquidity
A measure of how readily an asset, or a portfolio of assets, can be bought or sold in the market without affecting its price. Liquidity in a market is characterised by a high level of trading activity. Assets that can be easily bought or sold are known as liquid assets.

Maturity transformation
Activity performed by financial institutions in using short-term (often demand) liabilities to fund longer-term assets.

Moral hazard
Moral hazard is the risk that a party will alter its behaviour because it is not fully exposed to the consequences of its actions.

Mutual society
A mutual society is an organisation set up and run by its members. In the UK the mutual sector is dominated by building societies.

OTC derivative
A derivative is a financial contract the value of which is derived from one or more underlying assets or indicators such as equities, bonds, commodities, currencies, interest rates and market indices. An "over-the-counter" (OTC) derivative is a type of derivative that is entered into directly between two parties, without going through an exchange.

Re-financing risk
The risk that a borrower cannot raise funds to re-finance existing debt as it falls due.

Repurchase agreement/repo
An agreement whereby one party sells a security to another party, and agrees to buy it back at a later time (often the following day). The economic effect of a repurchase agreement is therefore similar to that of a secured loan. For the party selling the security (and agreeing to repurchase it in the future) it is a repurchase agreement; for the party on the other end of the transaction (buying the security and agreeing to sell in the future), it is a reverse repurchase agreement.

Retail & commercial banking
The provision of deposit-taking, payment and lending services to retail customers and SMEs (retail banking) and to larger companies (commercial banking).

RMBS
Residential mortgage-backed securities; ABS for which the underlying assets are loans secured on residential property.

Securities dealer
Non-bank firm the principal activities of which are dealing in securities on its own account and/or acting as a securities broker for clients, and also giving advice to clients.

Securitisation
The process of originating or purchasing cash flows from a pool of assets, packaging them into securities and selling these to investors. The assets that are most commonly securitised are residential mortgages (which are packaged into RMBS), but many other types of financial assets can also be securitised, such as commercial mortgages and credit card loans.

Shadow banking sector
Not all firms that conduct banking activities are banks, and non-bank institutions that conduct such activities are collectively referred to as the "shadow banking" sector. Examples of such institutions include hedge funds, securities dealers, insurers and SIVs.

SIV
A structured investment vehicle (SIV) is a company which funds the purchase of long-term instruments (such as ABS) through the successive issuance of highly rated short-term debt securities, typically commercial paper that is continuously renewed or rolled over. A SIV attempts to profit from the spread between the incoming cashflows it receives on the long-term securities it purchases, and the outgoing cashflows it pays to service the commercial paper it has issued. SIVs tend to be highly leveraged in order to maximise returns.

SMEs
Small and medium-sized enterprises.

Universal bank
A bank that undertakes both retail & commercial banking activities and wholesale & investment banking activities.

Wholesale & investment banking

The principal activities of wholesale & investment banking are the provision of financing to financial institutions and large corporations (wholesale banking) and the provision of assistance (including underwriting) to institutions such as governments and corporations in raising (equity and debt) finance, providing advice in relation to mergers and acquisitions, acting as counterparty to client trades and market making (investment banking). An investment bank may also undertake trading on its own account (proprietary trading) in a variety of financial products.

Annex 1: Banks and banking

What is banking, and what is it for?

1. Today's large banks are hugely complicated businesses with operations spread around the globe and balance sheets comparable in size to (and often bigger than) the annual GDP of entire countries. The experiences of the last few years have seen events in the banking sector – and the broader financial sector – spill over into the wider economy, triggering a global recession. The consequences have been severe, and without the intervention of national authorities around the world – requiring taxpayers to be exposed to enormous fiscal risk – they would surely have been far worse. It is therefore useful to remind ourselves what banks are for.

2. The key ways in which banks and other financial institutions can support the wider economy (and so society) are as follows:

- providing payment systems;
- providing deposit-taking facilities and a store-of-value system;
- lending to households, businesses and governments; and
- helping households and businesses to manage their risks and their financial needs over time.

Payment systems

3. Over time banks have developed complex networks that enable them safely and efficiently to transfer funds between different bank accounts. A payment system is the shared part of an end-to-end process that offers an account-based transfer service between two final customers and (usually) between two different banks. Payment systems sit at the heart of the banking system. Transfers can occur between personal customers, between businesses, or between personal and business customers. Payment systems are vital to the UK economy. Failure or disruption of a payment system could de-stabilise the financial markets and cause wider economic disruption.

Deposit-taking facilities and store-of-value system

4. The most visible function that banks undertake is to receive deposits from savers – the general public. Households in the UK are the ultimate holders of wealth in the UK, yet they are not well placed to look safely after and use that wealth effectively. When Samuel Pepys escaped the plague of 1660s London and recounted burying his money around his garden in the early hours of the morning, he represented the ever present problem of small wealth holders who, having earned that wealth through some endeavour, are unable adequately to protect it. Furthermore, money that is not engaged in productive activity will devalue over time as a consequence of inflation. Interest-bearing deposit facilities therefore act to store value.

Lending

5. However, banks do not take deposits simply to provide safety for the savings of the public. They use the cash that is deposited with them to provide loans to businesses to allow them to undertake productive economic activities, and also to consumers. The banks pay a premium (in the form of an interest rate) to depositors for the right to use their cash to make loans to other parties, and in turn charge interest on the loans they make to their borrowers. Banks make a profit by charging interest on loans at a premium to the rate they pay on deposits. Taking deposits, therefore, is not a public service undertaken by the banks, but the fundamental basis of their business. Banks take their aggregated deposits as a funding base from which they make loans to those that require them. And getting access to loans is advantageous to borrowers – and to the economy in general – because surplus capital is able to circulate, and be used in an efficient and effective manner, rather than simply sitting under the carpet in someone's home. An important element of banking activity that relates to lending is the provision of committed credit facilities, by which banks undertake (subject to certain conditions) to advance loans in the future at the borrower's request.

6. Unless (as with narrow banking) banks are required to have their deposits 100% backed by safe assets, this process of bank lending allows banks to create money – a fact of fundamental importance for the monetary system and the role of banks within it. Suppose, for example, that banks are required to maintain at least a 10% ratio of reserves to deposits. Then £1 million more reserves allows banks to make £10 million more loans, and the expenditure financed by them ends up as £10 million more in deposits in the banking system, hence £10 million more money in the economy. This is not to say that banks will necessarily wish to extend credit to the point where the reserve-to-deposit ratio is down at the 10% minimum allowed. A desire to build reserves in excess of regulatory requirements, or a pessimistic view about borrowers' ability to repay, might curb the degree of credit expansion, and hence of money creation by banks.

Managing risks and financial needs over time

7. Having access to banking facilities enables individuals and businesses to manage their risks and financial needs over time. At its most basic, this involves providing banks' customers with access to both borrowing and saving facilities. Banks' ability to manage risk is also fundamental to the value they add in other activities. For example, financial intermediation between retail depositors and business borrowers is advantageous to depositors as it ensures that they can get a return on their deposit, without needing to have specialist knowledge of the various activities that loans may fund, and they do not need to undertake extensive and in depth research on the companies receiving loans. The bank takes on the management of the various risks – such as credit risk, liquidity risk and interest rate risk – inherent in making and managing loans. The management of risk goes to the very heart of banking.

What are banks?

8. Banks are institutions that perform banking activities. But it is not that simple; not all banks perform all banking activities, and not all institutions that perform (some) banking activities are banks. Distinguishing features of banks are considered below.

9. In using deposits from some customers to fund lending to others, banks undertake financial intermediation. This typically requires maturity transformation, where a bank has liabilities that are of a shorter-term than its assets. This exposes banks to liquidity risk; if creditors are unable or unwilling to roll over a bank's liabilities – such as deposits, or bonds – then a bank may have trouble meeting its liabilities even if the value of its assets is greater than the value of its liabilities. The activity of maturity transformation exposes those institutions that undertake this activity to the risk of runs, where its depositors and/or creditors withdraw funds (which may well be put somewhere else in the banking system). A run on a bank can cause it to fail, even if it is fundamentally solvent.

10. A bank failure is likely to impact negatively on shareholders (the value of their shareholdings collapses), employees (who may lose their jobs), customers (retail customers may lose access to payment systems and businesses may be unable to borrow to fund socially useful investment projects) and creditors (who may not get their money back). But more seriously, it may have broader systemic implications. If one bank fails, this may cause creditors and depositors to worry about the safety of other banks, and so withhold funds from them. In a bank insolvency, its assets are likely to be sold off quickly; a fire sale will not only fetch low prices for the creditors of the insolvent bank, but will also depress prices more widely, potentially threatening the solvency of other financial institutions.

11. Recall that in the scenario under discussion here, these are costs arising not because a bank is fundamentally insolvent (in that its assets are worth less than its liabilities), but because it is suffering from liquidity issues. This is the kernel of the case for public

liquidity insurance of the financial system, set out by Walter Bagehot in the nineteenth century. The central bank, acting as lender of last resort, can create (or redistribute) liquidity around the system, and by undertaking to do this heads off the possibility of self-fulfilling worries about a run on an essentially solvent bank. *Banks have access to a central bank's lender-of-last-resort facilities*.

12. Another feature that distinguishes banks from non-banks derives from their role as deposit-takers. As will be clear from the description above, some banking activities expose banks to particular kinds of risk that companies operating in other sectors do not have to deal with. Yet fundamental to the risky activities that banks conduct is that they take in deposits from members of the public (and businesses). When a bank fails, its depositors may be exposed to the risk of losing some or all of their money. In order to reduce the chance of a bank failing, and so to lessen this risk, banks are required to be regulated, and to meet certain minimum standards in the way they conduct their business (and their depositors may also get the benefit of a depositor guarantee scheme). *In order to accept deposits, banks therefore have to be licensed and regulated as deposit-taking institutions*.[1]

13. Payment systems are essential to the functioning of the economy, enabling the movement of money to settle payments. Payment systems can be broadly divided into clearing schemes (BACS for direct debits and standing orders, CHAPS for real-time settlements, and CCCL for cheques) and plastic card networks (covering debit, credit and ATM cards). *Banks have access to payment systems*.

14. Not all financial institutions that conduct some or all banking activities are banks. At the retail end, building societies and credit unions undertake many (if not all) banking activities. And in wholesale & investment banking, many activities that fall within the description of banking activities above are also carried out by other institutions – such as hedge funds, securities dealers,[2] insurers and SIVs – that form the shadow banking sector.

Banking in practice

15. As described above in abstract, the management of risk goes to the very heart of banking. In undertaking maturity transformation in particular, banks manage a variety of risks, including:

(i) credit risk: the likelihood of default on a loan. Banks will often seek collateral against making loans to mitigate this risk;

1 Note that other types of institutions – such as building societies – can also be regulated to accept deposits.
2 Note that over the course of the financial crisis, the big US securities dealers either collapsed (Lehman Brothers), were taken over (Bear Stearns), or converted into bank holding companies (Goldman Sachs, Morgan Stanley).

(ii) liquidity risk: the difference between the liquid nature of deposits (which can typically be drawn upon by savers immediately) and the relatively illiquid nature of loans which have longer-term maturities. Banks need to manage the difference between these two so that they can meet the short-term demands of depositors for access to their savings; and

(iii) interest rate risk: interest rates vary over time, and therefore there is a risk that the cost of short-term funding can vary and so exceed the interest income earned by the bank as determined by the contractual rate on its longer-term assets (loans). Banks therefore need to price the cost and period of loans to reflect possible changes in interest rate.

16. Banks invest resources in order to be able better to assess their levels of risk and hence better price their assets and liabilities. Individuals are unlikely to be able to acquire the knowledge and understanding of a business in order to price accurately the risk of making a loan to it. The resources required to be able to get to know the business are beyond the value that most individuals can muster from their surplus wealth, and individuals are in any case less likely to be able to exploit economies of scale.

17. If a business is large, well-capitalised and fairly transparent, it might not be too costly for a number of investors to do to this job separately. In that case the business can issue bonds at a reasonable price. However, if a business is small, highly leveraged or hard for outsiders to understand, it will be more efficient for one agent to appraise the project, availing itself of private information in the process, and then capture the benefits by making a private, bilateral debt contract – a bank loan.

18. Bank behaviour is typified by the processing of information and monitoring of borrowers. As indicated above, banks can manage risk by assessing the various aspects of a proposal in detail and then making an appropriately priced loan. However, once a loan has been made, banks need to be sure that the debtor actually uses that loan for the agreed purposes and does not simply spend it all on, for example, consumption (unless permitted under the terms of the loan). Banks actively monitor the status of businesses to which they lend, and depending on the nature of the loan contract, may be able to change the terms and conditions to reflect the behaviour and circumstances of borrowers as they see fit.

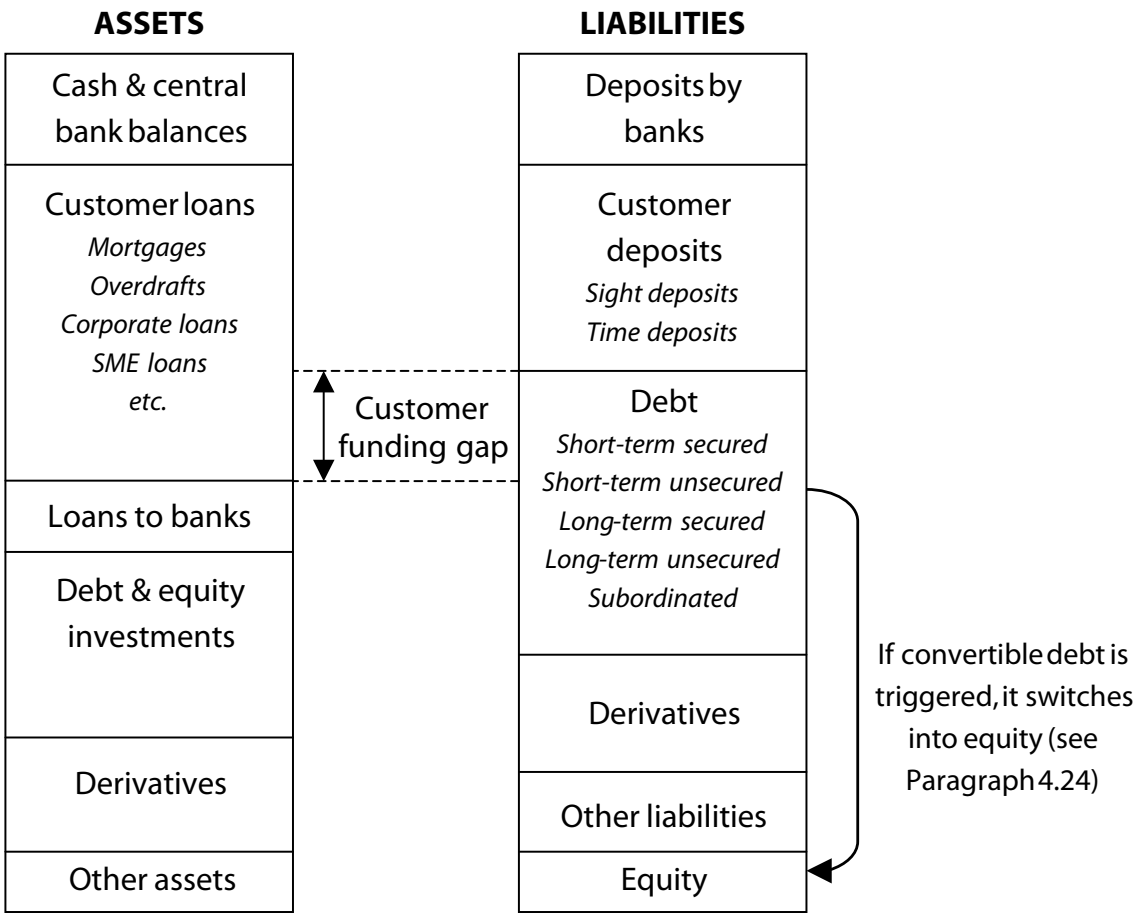
Assets, liabilities and equity

19. As with other companies, a bank's balance sheet sets out a description of its assets and of its liabilities. A bank funds itself by incurring liabilities – most notably customer deposits and debt (wholesale funding) – and uses these funds to make loans and investments which appear as assets on its balance sheet. Banks often monitor the ratio of customer loans to customer deposits with any shortfall in the latter – referred to as the "customer funding gap" – required to be filled with debt raised in the wholesale funding markets (see Figure A). In the event that these markets come

under stress, banks that rely heavily on such funding may suffer liquidity problems due to an inability to roll over maturing debt – particularly if there is a significant mismatch between the (long) maturity of their assets and the (shorter) maturity of their liabilities.

20. A bank's equity is the fully loss-absorbing part of its liability structure. Capital requirements mandate that the ratio of a bank's equity to its risk-weighted assets (its capital ratio) cannot fall below a certain level. Losses reduce the asset side of the balance sheet (as assets fall in value), but reduce the equity by the same amount (because equity is fully-loss absorbing); because banks are leveraged this results in the capital ratio declining. Contingent capital (one of the reform options discussed in Chapter 4) works by converting one part of the liability structure – debt – into fully loss-absorbing equity, thereby boosting the capital ratio (see Figure A).

Figure A: Stylised bank balance sheet



The UK banking sector

21. The UK has a large and concentrated domestic banking sector. Several of the largest UK-owned banks are universal banks which undertake both retail & commercial banking and wholesale & investment banking. Other UK-owned banks and mutual societies (principally building societies) focus on retail & commercial banking. The UK is host to a significant number of foreign-owned banks which operate here either through subsidiaries or branches; the focus of most of the large foreign-owned banks is on wholesale & investment banking. Foreign-owned banks located in the UK account for around 50% of total UK-resident banking assets. The aggregate balance sheet of the UK banking sector more than doubled in size between 2003 and 2008, from £3.5 trillion to £7.3 trillion.

Retail & commercial banking

22. The number of UK-wide full service independent banks[3] is limited to RBS, Lloyds Banking Group, Barclays, HSBC and Santander. Other full service banks with a national presence – for example NatWest, the Co-operative Bank and Alliance & Leicester – are owned by one of the big five or are otherwise part of a larger group. Standard Chartered is a large bank, but while it is headquartered in the UK, its principal retail presence is in Asia, Africa and the Middle East. There are few local or regional banks. Northern Rock, which used to be a medium-sized independent bank, was taken into public ownership in February 2008. Until the launch of Metro Bank this year, there had been no new high street bank (excepting de-mutualisations) for over 100 years.

23. In addition to banks, there are a number of mutual lenders and deposit-takers active in the retail banking sphere. The most prominent institutions in the mutual sector are building societies, of which there are approximately fifty across the UK. The dominant player is Nationwide, which accounts for more than half of the sector in terms of assets. Building societies tend to be more local and to have a more conservative business model, and many depositors choose to use them for their mutual corporate model. The mutual sector holds approximately £245 billion of savings.[4]

24. Credit unions also have a small presence in the UK market, with around £1.4 billion in assets. Over a million people are members of credit unions, which are local and restrict their membership to particular criteria such as geography or workplace. Credit unions have a particular role in increasing financial inclusion, typically providing relatively small value loans. The UK also has a small number of microfinance institutions making loans to individuals and businesses.

25. Together, banks and mutual societies account for the personal current accounts, personal loans, credit cards, savings and investments, mortgages and business

3 Excluding building societies.
4 http://www.bsa.org.uk/keystats/index.htm.

lending to SMEs that constitute the main retail products of the banking sector. However, it is worth noting that although most people hold one or more financial products, in 2007 there were still around 1.75 million adults in the UK without access to a current account.[5]

Wholesale & investment banking

26. There are no large, independent UK investment banks. The sector is made up of foreign-owned investment banks such as Goldman Sachs and Morgan Stanley, foreign-owned universal banks such as Credit Suisse and Deutsche Bank, and UK-owned universal banks such as Barclays and RBS. Despite the relative lack of UK-owned banks in the sector, London is a global financial centre, with a dominant position within Europe.

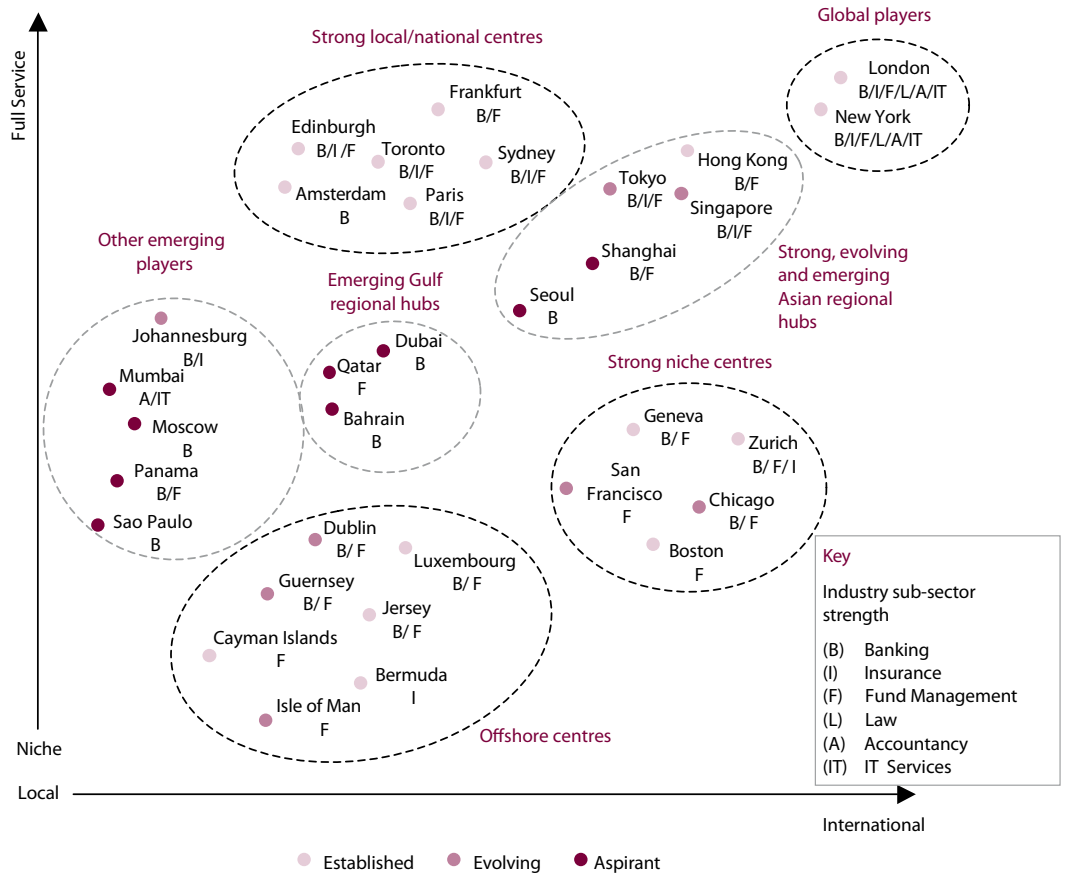
27. London's prominence is not limited to the banking sector. The UK has the highest global market share in OTC derivatives (46%), foreign exchange turnover (37%)[6] and cross-border bank lending (18%).[7] In hedge funds and private equity the UK is second-placed, after the US. London benefits from clustering effects and knowledge spillovers across the range of financial activities and supporting services (see Figure B)

Domestic perspectives – contribution to the economy

28. The UK's share of financial services to GVA[8] is high relative to most other major economies. There are a number of difficulties in measuring this accurately, but according to ONS calculations, this grew from 6.6% in 2002 to 8.3% in 2007, with the banking sector accounting for most of this (approximately 4.9% of GVA in 2007).[9] The financial sector provides a disproportionately high share of tax revenue. For the financial year 2007/8, financial services accounted for approximately 14% of PAYE revenue[10] and 27% of corporation tax receipts.[11] There are approximately one million jobs in financial services in the UK.[12] Banking sector net exports grew from around £11bn to around £30bn from 2003 to 2008.[13]

5 Financial Inclusion Taskforce Fourth Annual Report on Progress Towards the Shared Goal for Banking: http://webarchive.nationalarchives.gov.uk/20100104214853/http://hm-treasury.gov.uk/d/fourth_annual_banking_report.pdf.
6 http://www.bankofengland.co.uk/publications/news/2010/066.htm.
7 http://www.thecityuk.com/media/154873/ifm%20in%20the%20uk%2005%202010.pdf.
8 Gross value added = GDP – taxes on products + subsidies on products.
9 ONS Blue Book 2010: http://www.statistics.gov.uk/downloads/theme_economy/bluebook2010.pdf.
10 http://www.hmrc.gov.uk/stats/income_tax/table2-10.pdf.
11 http://www.hmrc.gov.uk/stats/corporate_tax/table11-5.pdf.
12 http://www.thecityuk.com/media/154873/ifm%20in%20the%20uk%2005%202010.pdf.
13 ONS Pink Book 2010: http://www.statistics.gov.uk/statbase/product.asp?vlnk=1140.

Figure B: Principal international financial centres



Source: UK international financial services – the future (2009): http://webarchive.nationalarchives.gov.uk/20100407010852/http://www.hm-treasury.gov.uk/ukinternational_financialservices.htm

Annex 2: Regulatory reform developments

1. The financial crisis exposed a number of significant weaknesses in the financial system. A number of initiatives have subsequently been launched at global, regional and national level to address these weaknesses and to reduce both the probability and impact of a future crisis. This annex briefly summarises the key developments of these initiatives.

Capital requirements

2. The Basel Committee on Banking Supervision (BCBS) is the global standard-setter for bank capital requirements and its recommendations are largely adopted[1] across all major banking systems.[2] Following the crisis, the BCBS has announced a substantial strengthening of capital requirements (colloquially known as Basel III) to remedy the deficiencies that became apparent in its existing standards (Basel II). In short, banks took advantage of regulatory capital arbitrage opportunities under Basel II such that an appropriate level and quality of capital was not always held against risk exposures.

3. The Basel III changes will increase capital quality by placing greater emphasis on its capacity to absorb losses on a going concern basis. The required quantity of capital will also increase for certain asset classes (e.g. trading book assets, (re)securitisations) and at the institutional level (e.g. higher minimum capital ratios, supplementary leverage ratio). In addition, a capital conservation buffer (requiring banks to retain capital above minimum requirements during normal times that can be called upon in a stress) and a countercyclical capital buffer (requiring banks to hold more capital to rein in an impending credit boom) will increase the resilience of banks to shocks and form part of a framework of countercyclical measures to dampen the impact of peaks and troughs in the economic cycle.

4. While the overall implementation timetable for Basel III extends out to the end of 2018, some components will take effect from the end of 2010 and market expectations are already aligned with the need for banks to comply with the revised standards.

1 Note that the Basel II standards have not been adopted in the US.
2 The Capital Requirements Directive implements the BCBS recommendations as binding requirements for EU member states.

Liquidity requirements

5. In an environment of abundant liquidity prior to the crisis, insufficient emphasis was placed on managing the risk that material funding sources might evaporate. In practice, this was the trigger for several bank failures. The BCBS is seeking to address this issue through a combination of qualitative and quantitative measures, with the latter forming part of the Basel III changes.

6. The qualitative measures aim to improve liquidity risk management by requiring banks to: establish a liquidity risk tolerance level; use a range of tools to monitor risk against this level; develop contingency funding plans; and ensure appropriate board and senior management oversight of liquidity risk. The quantitative measures require banks to hold sufficient high quality liquid assets to survive a one month liquidity stress and to reduce their reliance on more volatile, short-term funding.

7. In December 2009, the UK Financial Services Authority (FSA) introduced an enhanced liquidity regime implementing the BCBS qualitative measures and proposing quantitative requirements to be phased in as economic conditions improve.[3]

Accounting standards

8. The crisis raised concerns that accounting standards were inadequate, unco-ordinated and pro-cyclical. The highly specific, rules-based US Generally Accepted Accounting Principles (US GAAP) allowed novel and hybrid securities to remain off US bank balance sheets. This has given extra emphasis to the drive to converge US GAAP with the principles-based International Financial Reporting Standards (IFRS), which are themselves being revised to account better for off-balance sheet exposures, hedges and controlled or special purpose entities. Convergence is expected to be completed in 2011 and could prompt the Securities and Exchange Commission (SEC) to adopt IFRS as mandatory for US-listing companies from around 2014.

9. Pro-cyclical concerns have centred on fair value (or "mark-to-market") accounting and on incurred loss provisioning, which can cause financial firms to adjust their asset values downwards drastically in a financial crisis. Among other reforms the new IFRS9 proposes a move away from incurred loss provisioning to an expected loss model. However, the benefits of fair value are seen to outweigh the disadvantages, and exemptions from fair value have been pared back in IFRS9.

10. The European Commission has suspended the transposition of IFRS9 into EU law, partly over concerns about the fair value model. On the assumption that IFRS9 does progress at EU level in due course, it will then be subject to further domestic interpretation and transposition in the UK by the FSA.

3 These requirements have not yet taken effect, with the FSA due to update its position in Q4 2010.

Remuneration

11. Weaknesses in the capital and accounting frameworks prior to the crisis enabled some bank employees to be remunerated on the basis of reported profits that were neither time- nor risk-adjusted and led to employee incentives that were not always aligned with the long-term interests of the bank. In the UK, the FSA introduced a Remuneration Code to address these issues and is consulting on revisions to the Code which will take effect from 1 January, 2011. The Code requires remuneration policies to be consistent with and promote effective risk management. Restrictions on the mix (e.g. salary vs. bonus), form (e.g. cash vs. shares) and timing of employee remuneration will apply to all staff "who have a material impact on the firm's risk profile".

Hedge funds

12. The increasing systemic importance of hedge funds has led authorities to review the regulatory requirements placed on their managers. The EU is proposing a new Directive on Alternative Investment Fund Managers (AIFMs) which will introduce authorisation and regulation requirements for AIFMs and regulatory standards for depositaries and administrators, minimum capital requirements related to portfolio size, governance and risk management requirements and enhanced transparency for investors and supervisors. The directive will also allow EU-wide marketing of hedge funds through a passport scheme but will restrict sales of unregulated funds within the EU (including non-EU funds).

13. In the US, the Dodd-Frank Act requires advisers to funds of over $100m to register with the SEC as investment advisers and to be subject to reporting and record-keeping requirements.

Credit rating agencies

14. The crisis also showed credit rating agencies (CRAs) to be systemically important given the reliance placed on ratings by both investors and regulators (through capital requirements). Ratings assigned to the alphabet soup of structured financial instruments proved to be inaccurate, often by a wide margin, raising concerns about the effectiveness of CRAs' financial models and the management of conflicts of interest inherent in the "issuer pays" business model. A new EU Regulation on CRAs and the Dodd-Frank Act have both introduced a number of reform measures including granting supervisory powers over CRAs, imposing activity restrictions and enhancing transparency requirements. Rating integrity is addressed in the EU by a requirement for effective systems and controls around financial models and in the US by the empowerment of the SEC to fine or revoke the licences of poorly performing CRAs.

Derivatives

15. Derivatives can transfer risk from one counterparty to another who is more willing or able to bear it. In theory, the rapid growth of derivatives in the run up to the crisis represented an ever more efficient allocation of risk across the financial system. In practice, a lack of transparency and standardisation of derivative contracts and a growing use of derivatives for speculative purposes meant that this growth resulted in greater interconnectedness between counterparties and hence greater systemic risk. A number of workstreams are under way on the regulation of derivatives, in particular OTC products. Market participants are being encouraged to standardise OTC derivatives where possible, and clear them through a central counterparty (CCP). To support this objective, non-standardised contracts will attract higher capital and margin requirements. Transparency will be improved by requiring all OTC derivative transactions to be reported to a trade repository which will collate and distribute this information both to regulators and to the market. CCPs themselves will become subject to appropriate regulation and supervision.

16. The EU has published proposals on OTC derivatives which include mandating central clearing where appropriate, and new prudential and organisational standards for CCPs. The EU is also proposing several restrictions on speculative trading including a ban on such trading in credit default swaps (CDS), in effect requiring firms to have a position in the underlying entity in order to trade CDSs. The EU is also considering requiring greater disclosure of short positions.

17. In the US, the Dodd-Frank Act requires derivatives trading operations to be spun-off into non-bank affiliates, which cannot benefit from federal assistance (e.g. lender-of-last-resort facilities).

Supervisory framework

18. The crisis highlighted the international nature of financial markets and the need for supervisory authorities to operate effectively on a cross-border basis. Requirements are due to come into force from January 2011 under which regulators must improve their co-ordination through supervisory colleges, better information sharing and crisis management arrangements, and agree capital requirements for cross-border entities.

19. The EU is establishing three new authorities to oversee banking, securities & markets and insurance & pensions, and also a European Systemic Risk Board. The UK is replacing the current Tripartite system and creating a number of new bodies: the Prudential Regulatory Authority as a subsidiary of the Bank of England (the Bank) to be in charge of supervising individual firms; the Financial Policy Committee within the Bank to be responsible for macro-prudential supervision; and the Consumer Protection and Markets Authority to be responsible for conduct of business regulation, markets supervision and consumer protection. White collar crime will be

addressed through a new agency created from elements of the OFT, the FSA and the Serious Fraud Office.

20. The US is undertaking similar activities, including establishing a Financial Stability Oversight Council.

Governance

21. The Walker Review was commissioned in February 2009 to review corporate governance in the UK banking sector in light of the failings evident from the crisis. The review makes recommendations on: the size, composition, qualification, functioning and performance evaluation of boards of directors; the role of institutional shareholders; risk governance; and remuneration. Many of these recommendations are reflected in the updated Financial Reporting Council Corporate Governance Code which took effect from June 2010.

Tax

22. In the UK, a tax of 50% on bonuses over £25,000 paid to banking employees between 9 December, 2009 and 5 April, 2010 was introduced. This was followed by similar measures in France and Germany.

23. The UK has announced that it will introduce a levy based on banks' balance sheets from 1 January, 2011. The levy is intended to encourage banks to move to less risky funding profiles and to ensure that they make a fair contribution in relation to the risks they pose. The tax is calculated with reference to a firm's liabilities (subject to certain carve-outs, such as retail deposits). Sweden has introduced a banking tax to finance a resolution fund, and in the US, President Obama has announced an intention to introduce a "financial crisis responsibility fee" to pay for the costs of the recent crisis. There is also some discussion (both within the UK and internationally) of a financial activities tax.

Systemically important financial institutions (SIFIs)

24. The Financial Stability Board (FSB) is developing proposals to address the role of SIFIs and the risk they pose to financial stability. This is to include: enabling failing SIFIs to be resolved safely; increased prudential requirements together with structural and other constraints for SIFIs; effective supervisory oversight of SIFIs; robust core financial market infrastructures; and global consistency and co-ordination.

Recovery and resolution plans / living wills

25. A key element of the FSB's work on SIFIs is the need for these firms to have effective recovery and resolution plans in place: the former, to minimise the likelihood of requiring resolution through appropriate planning of capital, liquidity, asset sale and run-off options if a firm encounters a severe stress; and the latter, to enable authorities to act on a swift and well-informed basis to resolve a failing firm – for example, through the sale of parts of the firm to private buyers, creating a bridge bank or an orderly liquidation. The process of creating resolution plans may also highlight issues with existing bank structures or market practices that could prompt authorities to seek structural and/or legal changes to enable resolution without recourse to taxpayer funds. The FSA is currently carrying out a pilot exercise on recovery and resolution plans with a small number of banks in the UK; it will use the evidence it gathers from this exercise to develop proposals for consultation in 2010/11.

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