



**Barclays response**

**Independent Commission on Banking**

**Issues Paper: Call for Evidence**

**15 November 2010**

## Executive Summary

- a) Barclays welcomes the work being undertaken by the Independent Commission on Banking and fully supports the need to enhance financial stability, reduce systemic risk and achieve greater competition in the UK banking sector. An optimal outcome, in our view, would be a set of recommendations from the Commission that would enable banks to support economic growth and job creation within a stable regulatory framework that maximises the international competitiveness of the UK as a financial centre.
- b) Financial institutions are socially useful if they create explicit value for their customers, their employees, the communities in which they operate, taxpayers and their owners. The contribution of UK banks to UK society is, therefore, best made through: lending; managing risks on behalf of customers; employment; payment of tax; and the payment of dividends. The scale of each of these components of contribution within the UK is profoundly affected by the ability of the UK industry to compete with both UK and international peers. The best way to maximise the contribution of UK banks to UK society is, therefore, to allow them to compete strongly within a secure regulatory framework.
- c) Since the start of the financial crisis, international, regional and national authorities have: improved supervision; enhanced depositor protection; made banks safer; and reduced the impact of a bank failure on the financial system. Many other reforms are in train at multiple levels to make further improvements in those same areas and others. In aggregate, these measures will ensure that, in the future, the failure of an individual financial institution is both less likely and, if it does occur, it does not pose the same risk to financial stability as prior to 2009.
- d) Well-run large cross border banks have developed into their current form in response to customer needs. The industrial and commercial world has globalised to an unprecedented extent, and the trend towards globalisation is increasing. The global economy is becoming more sophisticated. So too are the needs, not just of large companies, but also, increasingly, of small and medium sized enterprises – because of the growing importance of overseas markets to their success, banks need to be able to support these businesses' ability to grow internationally. The footprint of broadly based banks, and their range of services, is simply the banking sector's response to the emergence and evolution of these customer requirements. Our belief is that the broad product and service capabilities of universal banks bring significant benefits to customers, the wider economy and the financial system, including:
  - I. Greater choice and availability of services for customers;
  - II. Lower costs for customers and clients;
  - III. Better service for business customers and corporate clients;
  - IV. More efficient use of capital and liquidity resources; and
  - V. Greater resilience and ability to absorb shocks and recover from stress.
- e) Banking supports economic growth through the safe storage of money; maturity transformation; and by enabling customers and clients to assume or transfer risk

according to their needs. No banking regime can remove that risk entirely without fundamentally altering the overall economic landscape. However, the financial system must be able to accommodate the failure of an individual institution without recourse to taxpayer support.

- f) There is little empirical evidence to suggest that structural change would enhance financial stability, not least because the cross border nature of banking risk makes it very difficult for risk to be isolated in, or contained by, national boundaries. The costs of such structural change to customers and the wider economy are certain and high, and the implementation risks are material.
- g) Given the uncertainty associated with the benefits of material structural change, and recognising the significant costs and risks associated with such change, we believe the Commission's starting stance should be one of cautious deliberation. The evidence for change needs to be overwhelming for it to be undertaken.
- h) Diversity of business model, size and type of bank is a source of defensive strength in the financial system and of competition. These characteristics should be protected and, absent strong evidence suggesting specific models are inappropriate, institutions should be free to pursue the model that best suits their strategy.
- i) Efforts to strengthen financial stability beyond the changes already brought to bear on the system, and institutions within it, should focus on the orderly resolution of a failing bank. The suite of crisis management and resolution measures currently being explored by the Financial Stability Board and the European Commission is focused precisely on this and will shift the burden of bank failures from taxpayers to financial markets and impose greater market discipline.
- j) The Commission could and should have a significant influence in the area of international conformity by stressing the importance of consistency in both the substance and the implementation timetable of reform.
- k) Some banking markets have become more concentrated through the crisis. National authorities were compelled to make interventions in a number of jurisdictions that resulted in distortions to normal competitive markets. These actions should be reviewed and any steps necessary taken to ensure that effective competition in all banking markets can prevail.
- l) In the UK, improvements can and should be made to the regulatory framework for financial services to promote effective competition, and the new Consumer Protection and Markets Authority should be given a statutory objective to promote effective competition.
- m) The task before the Commission is, from our perspective, immense. Its recommendations will define the shape of the UK banking system and, therefore, the UK economy for generations to come. For these reasons, it is critical that the Commission

undertake its work in a fact-based and rigorous way. However, the objectives set out in the Commission's terms of reference are overlapping and, in some instances, contradictory. The fundamental purpose of banks is to take and manage risk on behalf of their customers in order to support economic growth and job creation. But banks must pursue that objective in a way that delivers those outcomes sustainably, so the banking system must be stable through time. The Commission's recommendations regarding financial stability must, therefore, be optimised to deliver long-term sustainable economic growth and job creation.

## 1. Introduction

- 1.1 Barclays welcomes the work being undertaken by the Independent Commission on Banking and the opportunity to respond to its Issues Paper and Call for Evidence. As a leading global bank, based in the UK, the issues under consideration by the Commission are important to our ability to serve our customers and clients. We are pleased, therefore, to have this opportunity to contribute evidence and stand ready to support the work of the Commission. For some time now, there has been uncertainty around the future shape of the industry, and Barclays looks forward to the completion of the Commission's work so that the UK banking sector can benefit from the regulatory certainty that other markets are now starting to move towards.
- 1.2 Banks play an important role in society. They provide essential financial services to households and businesses. Supporting customers through strong, sustainable and focussed relationships in a responsible way is at the core of successful banking. Banks play an important role in providing consumers with access to banking services that enable them to live their lives day to day and achieve their goals and aspirations: facilitating payments and financial transactions; supporting small and medium sized enterprises through finance and advice; enabling investments in infrastructure and private finance; and helping businesses to take and manage their risks so that they can grow as quickly as possible. Banks also intermediate between suppliers and users of capital in the market. All these functions are essential to the proper workings of a modern market economy. Reform initiatives must recognise the retrograde economic impact of limiting or eliminating any of them.
- 1.3 All banking activity – whether agreeing an individual's mortgage; lending £10,000 to a small business; helping a farm or large company hedge commodity price risk; or helping a government price and sell its bonds – involves the taking of risk by a bank. Banks by their very nature, therefore, must carry and manage that risk in order to meet the needs of their customers and the economy. Removing that risk from banks implies either removing it from the economy or placing it outside of the regulated banking sector. The former would simply limit the range of activities that can be undertaken in the economy. The latter could have material negative consequences for financial and economic stability. The preferred option must be for that risk to be safely and properly managed by the banks. The Commission will, therefore, need to weigh the balance between making the financial system safer and the need for banks to take appropriate risks within a proper risk management framework and fully competitive environment.
- 1.4 The banking system, by its nature, is interconnected and will need to remain so if its customers are to be able to: make payments from their account to someone else's; buy homes with reasonable access to mortgage funding; invest their savings in ways that allow their money to grow; and borrow funds to set up a new business. If businesses are to get the support they need to grow, they need to be able to hedge their risks and trade internationally. All of these services require banks to work with each other.

- 1.5 In the 21<sup>st</sup> century, the economy has globalised to an unprecedented extent, and it is no longer possible to insulate any major economy from the global system, as the recent financial crisis has demonstrated. As a result, the banking system has become global too. Measures taken in one country alone to reform its banking system would not only distort competition between global financial centres, but would also not prevent systemic risk being imported from elsewhere. In recognition of this, the G20 nations have rightly invested significant effort in developing an internationally agreed framework for reforms to strengthen financial stability.
- 1.6 Experience tells us clearly that measures that distort competition between global financial centres create a significant economic cost. One example would be the implementation of the Sarbanes Oxley Act in the US. This was an attempt, in one jurisdiction, to tighten regulation in response to the events of the failure of Enron. In practice, its main consequence was to increase considerably the cost of being SEC regulated and make companies reluctant to register in the US under SEC regulation. While that did not have an immediate impact on the competitiveness of New York as a financial centre, over the course of a number of years after its implementation, its impact was real and significantly negative: for example, the international IPO market moved East at great cost to the New York economy.
- 1.7 Large, complex, global banks have evolved and developed to meet the needs of customers and clients whose requirements are global in nature and are best addressed by the services that universal banks can offer. There is a strong correlation between the size of industrial companies (which is usually driven by their global activity) and the size of the banks within that market serving them (which in many cases corresponds to them being more global). This illustrates how the existence of, and enduring business rationale for, universal banks corresponds directly with the needs of the customers that they serve.
- 1.8 As the Commission notes in its Issues Paper, the causes of the recent financial crisis were complex. Mistakes by banks, of course, contributed to the genesis of the crisis, and to its depth. But there were many other sources too, including: global economic imbalances; the search for ever higher yields by investors; mark-to-market accounting; the widespread outsourcing of credit judgements to credit-rating agencies; sub-optimal supervision of financial institutions; the lack of macro-prudential oversight; and an unsustainable monetary policy environment. In the range of incremental reforms that it recommends, the Commission should ensure that there can be no repeat of the causes of the recent financial crisis, but it is also important that the wide range of factors that caused the crisis are taken into direct consideration in that evaluation.
- 1.9 The short term actions taken by the governments and authorities around the world in response to – and in the midst of – the financial crisis materially changed the financial services landscape in many jurisdictions. The time is now right to assess fully whether or not those changes are appropriate over the long term.

- 1.10 It is vital, however, that any remedial action that the Commission deems appropriate for the long-term (whether to do with structural change or not) is signalled and implemented in a way that protects the ability of the banking system to support the fragile economic recovery. In particular, the Commission will need to give great care to how its emerging thinking is signalled in the Spring.
- 1.11 The Coalition Government has made clear its intention to rebalance the economy. The success in doing so will depend to a large part on the UK's ability to grow its trade with the rest of the world, but particularly new and emerging economies. India and China are two countries that have recently played host to UK Government led trade delegations, in which Barclays participated. UK businesses will need the support and services of strong, efficient and global banks that can help them maximise their export potential. If those banks did not exist in the UK, the requisite services will simply be imported.
- 1.12 In other words, a major and unilateral change to the structure of UK banks would not simply lead to a reduction in the competitiveness of the UK banking industry. If broadly-based banks were prevented by major structural reform from serving the needs of the customers who today require their services, those banks would atrophy, with significant implications for the contributions to UK society that those banks can make.
- 1.13 Since the crisis started, there has been much commentary about the relationship between the size of the financial services sector within a country and that country's GDP. In the UK, the financial services industry accounts for 8.5 per cent of GDP and is one of the UK's economic and international success stories. The size of the overall UK economy is critically dependent on the supply of patient and competitively priced credit by major banks.
- 1.14 Financial services are one of the UK's primary exports. Our analysis suggests that 8.5 per cent is not a disproportionate ratio. If the policy goal is to reduce this proportion, it must be pursued by causing the rest of the economy to grow faster, not by shrinking the size of the financial services sector. Doing otherwise would simply reduce the overall size of the UK economy.
- 1.15 Finally, we note that the financial services industry contributes to the economy in many ways beyond the services it provides to customers and clients. For example, the banking sector is a clean, low carbon industry that does not rely on natural resources and provides direct employment to more than 1 million people and indirect employment to more than 3 million.
- 1.16 Barclays response addresses the range of analyses on which we believe the Commission will need to form a judgement in order to make recommendations on the need for further reform.
- 1.17 In Section 2, we argue that much has changed to make banks safer and less likely to fail, and that the impact of failure, should it occur, has been reduced materially. Other measures currently under implementation, review or discussion will further strengthen

the resilience of the financial system and reduce the impact of the failure of an individual institution. This section also highlights the negative consequences of any unilateral action by the UK on the competitiveness of UK banks; the attractiveness of the UK as a place to do business; and the long term prospects of the UK economy.

- 1.18 In Section 3, we explore the interrelationship of financial stability and competitiveness and conclude that it is critical that the Commission pay due regard to the impact of its recommendations on UK banks' ability to compete with international peers.
- 1.19 In Section 4, we turn our attention to the special case of large, cross-border banks (so-called "universal banks"). We analyse the particular contribution that universal banks make to the wider economy and financial stability, concluding that universal banks provide unique benefits to customers and clients and that, if well-run, provide resilience and stability to the financial system.
- 1.20 In Section 5, we address the important role that competition has to play in facilitating a well functioning market and acknowledge that the financial crisis precipitated increased concentration in certain markets with consequences for competition.
- 1.21 In Section 6, we assess the fundamental question of what further reform is necessary and conclude that the orderly resolution for failing firms is still a critical issue to be addressed. Failing financial institutions of any type or size must be able to be resolved in a way that does not create systemic effects in the financial system or require the taxpayer to step in.
- 1.22 In Section 7, we assess the effectiveness of the structural options for reform set out in the Commission's Issues Paper, especially in addressing the reform gap identified in Section 6. We conclude that none of the structural options for reform under consideration by the Commission offer major additional benefits to financial stability (and are just as likely to pose further risks). We also conclude that what benefits may develop do not sufficiently outweigh the considerable negative implications for customers and clients and economic growth. We also highlight several significant risks and complexities involved with the implementation of such reforms, should the Commission determine these are necessary.
- 1.23 In Section 8, we set out the reform measures that we believe would address the critical issue of resolvability highlighted in Section 6. We also emphasise the important role that the Commission could and should play in helping the UK Government to facilitate the delivery of a coordinated international regulatory framework that recognises both the long-term and transitional economic impacts.
- 1.24 Our response concludes (in Section 9) with a list of the broader set of specific measures to which we believe the Commission should give further consideration.

## 2. Background

### Many reforms to the financial system are already in place or are being implemented

- 2.1 Significant steps have been taken by governments and supervisors in response to the recent financial crisis to strengthen financial stability by reducing the likelihood and impact of a firm failing and creating systemic risk.
- 2.2 The most prominent of those reforms are the proposals from the Basel Committee of the Bank for International Settlements (the so-called Basel 2.5 and Basel 3 packages) for reform to risk-weightings (particularly for activities in the trading book), capital requirements, liquidity requirements and leverage, which were recently adopted by the G20 Leaders. These reforms will lead to significantly stronger prudential regulation of banks.
- 2.3 A range of other reforms has already been implemented or is well advanced towards implementation at the international, regional and national level, for example:
  - a. The 2009 Banking Act in the UK that established Special Resolution Regimes, with Special Administration Regimes also being introduced for investment banks;
  - b. Work underway between certain pilot banks (including Barclays), the Financial Services Authority (FSA) and the Bank of England to develop Recovery and Resolution Plans (also known as “living wills”) to facilitate orderly resolution in the event of the failure of an institution;
  - c. The FSB and EU are developing policies on crisis management frameworks and statutory bail-in regimes;
  - d. European Market Infrastructure Regulation (EMIR) in the EU will address Over the Counter (OTC) derivatives, central counterparties and trade repositories and insulate counterparties from a bank failure, significantly improving market stability;
  - e. The EU is creating a European Systemic Risk Board and Banking Supervisory Authorities, which will provide early warnings, enhance cooperation, ensure consistency and reduce the probability that the failure of an individual institution becomes systemic;
  - f. In the US, the Dodd-Frank Act put into place, among other things, a mechanism for the orderly wind-up of failed banks and bank holding companies;
  - g. Crisis Management Groups have been formed for all major international financial groups to improve coordination during a crisis, and supervisory colleges are already operating on a cross border basis for major firms; and
  - h. Depositor protection has been significantly strengthened in the UK and the EU is consulting on further measures to put in place a consistent depositor protection framework across the EU.
- 2.4 Barclays anticipation of, and response to, these measures exemplifies the impact that reforms have already had on the resilience of, in particular, UK banks. Since just before the start of the crisis in 2007, Barclays Core Tier 1 capital ratio has more than doubled from 4.7 per cent to 10 per cent. The buffer of liquid assets that we hold has increased from £36 billion in 2008 to £160 billion. Our reported leverage ratio has fallen by more

than one third – from 33x to 20x. These are changes that we have taken both proactively, and in response to, new requirements of the UK FSA.

### **Significant improvements to the governance and oversight of banks have been put in place**

- 2.5 Weak corporate governance at specific institutions is widely regarded as one of the key causes underlying the recent financial crisis. Strengthened corporate governance will make banks safer in the future. In the UK, many of the proposals contained within the Walker Review advocated good practices that are already undertaken within some banks, including Barclays. For example, Barclays has had a dedicated Board Risk Committee, comprising Non Executive Directors, for many years. This committee has the power to call for independent external advice and undertake deep dives and stress tests in areas it deems to be high risk.
- 2.6 The Financial Stability Board has also published global guidance on remuneration policy and structure, recognising the role that remuneration played in the crisis. The FSA has since implemented its Remuneration Code, which has reformed the pay structure in the institutions which are supervised by the FSA, including Barclays. The European Commission will bring further changes to pay structure and disclosure through requirements that have been incorporated in the Third Capital Requirements Directive (CRD3), which the FSA has made clear will be reflected in its Code. Barclays agrees strongly with the need to have global standards for ensuring remuneration incentives are aligned with prudent risk taking. We have always had a significant element of deferral in our remuneration structures.
- 2.7 Supervisors have also recognised the need to strengthen their capabilities and to apply better judgement to the oversight of banks and other financial institutions. Stress testing (including reverse stress testing) has become a powerful new supervisory tool as a result. In addition, central banks and supervisors are now beginning to coordinate across different financial markets so that they can better respond to a crisis as it unfolds. Supervisors of large, cross-border institutions are actively cooperating in Supervisory Colleges to ensure that there is a shared understanding of the institution's business model and risk profile, enabling appropriate supervision of all parts of the firm. Crisis management groups have been created, comprising the finance ministries, central banks and supervisors of the major markets of each large, cross-border institution to enable crisis management planning to take place and enhanced coordination capabilities in a stress situation. Barclays welcomes all of these supervisory enhancements and believes that their successful operation will be critical in preventing a future financial crisis and limiting the impact of any crisis that does arise.
- 2.8 The need to identify and respond to system wide (so-called 'macro-prudential') risks, particularly from emerging asset bubbles, is also widely regarded as a critical lesson to be learned from the recent crisis. This is being addressed at international, regional and national levels. In the UK, the Government will create a new Financial Policy Committee, to be chaired by the Governor of the Bank of England, with new powers and tools to take action if systemic financial risk appears to threaten the stability of the UK economy.

## **A wide range of other reform measures is also under development**

- 2.9 Further regulatory reforms are currently in progress that will strengthen the resilience of banks and reduce the likelihood and impact of their failure, including:
- a. New countercyclical capital buffers that will come into effect if an economy appears to be over-heating;
  - b. Specific additional measures, as proposed by the Financial Stability Board, for institutions deemed to be systemically important (including more intensive supervision; higher loss-absorbing capacity; cross-border resolution plans);
  - c. Further reforms to activities within banks' trading books;
  - d. Increased standardisation of derivatives, central counterparty clearing of standardised derivatives to reduce contagion risk between counterparties and sharing of information on non-standard derivatives;
  - e. Strengthened depositor protection across the EU, including faster payout and higher guaranteed levels for individuals;
  - f. Recovery and resolution plans for banks and other institutions, as required by the 2009 Financial Services Act in the UK; the Dodd-Frank Act in the US; and the FSB for systemically important institutions;
  - g. EU proposals to strengthen crisis management, including special resolution regimes (similar to that already in place in the UK) in all member states; and
  - h. FSB, EU and UK policy development around the use of contingent convertible capital (so-called CoCos) and the establishment of an international statutory "bail-in" regime as additional recovery and resolution tools.
- 2.10 Some jurisdictions have implemented other, local reforms. For example, in the US, the Dodd-Frank Act will prevent deposit taking institutions from participating in proprietary trading where they take risk as principal. As a result, US banks will be allowed to allocate no more than 3 per cent of their total Core Tier 1 capital to either hedge fund or private equity businesses. Commodities and equity derivatives trading business will need to be carried out by separately capitalised businesses. The Act also provides new powers to US authorities to enable the orderly resolution of large complex firms. However, these provisions are not yet defined in detail and regulators are required to write the specific rules following the completion of a number of impact studies. Consequently, the impact of these rules is difficult to assess. If the rules are inappropriately defined, we believe the provisions could lead to significant costs for clients and the economy, affect the efficiency of markets and possibly result in the movement of some business to more conducive regulatory regimes.

## **The financial crisis had a material impact on competition in many markets**

- 2.11 There have been numerous studies, inquiries and investigations into competition in the UK banking market over the last 10 years.
- 2.12 However, the structure of the market has changed significantly as a result of the financial crisis. A number of foreign institutions have exited the UK market (for example, the British Bankers' Association (BBA) estimates the withdrawal of lending capacity by

foreign banks to be 35 per cent of total capacity), and the failure of others has led to some consolidation. The impact of these effects has been somewhat mitigated by the entrance of strong new players to the market.

- 2.13 While the UK banking market remains highly competitive in terms of the provision of full banking services and mono-line (or niche) competition offerings, the Commission should consider the impact of the interventions by Government and consolidation in the retail banking sector on future competition.
- 2.14 In particular, consolidation during the crisis has resulted in increased concentration in certain UK retail banking products.
- 2.15 Section 5 considers some of these issues in more detail.

#### **The impact of regulatory reform on bank lending and the economy needs careful scrutiny**

- 2.16 The Commission should have regard to lending conditions and the impact of any of its recommendations on economic recovery.
- 2.17 Banks' ability to lend, and the price at which they are able to lend, are directly influenced by the regulatory and market environment in which they operate. The cost of funds (whether obtained via retail or wholesale channels), the cost of capital, and the estimated cost of potential default are all input costs in the construction of a loan to an individual or a business. All have a direct impact on the pricing an individual bank considers appropriate for the borrowing of a particular customer.
- 2.18 It is vital, therefore, that the impact of any regulatory reforms on these, and other cost factors (such as levies and liquidity requirements), is understood before reform is agreed so that the impact on the availability and price of credit, and hence on the economy, can be directly assessed.
- 2.19 The determination of whether or not to adopt a particular reform should make that assessment based on the long-term impacts. The determination of how to implement any necessary reform must also take account of those impacts over the short and medium-term. The latter will be particularly important in light of the confidence required in the markets as customers refinance over the period of implementation. For instance, the volume of UK refinancing activity in the UK is likely to pick up significantly over the coming years. Estimates suggest that the maturing debt total for UK businesses in 2011 is £86bn, with almost twice this level of debt maturing in 2012. We think it is very unlikely that an industry uniquely comprising narrow banks could provide that finance.

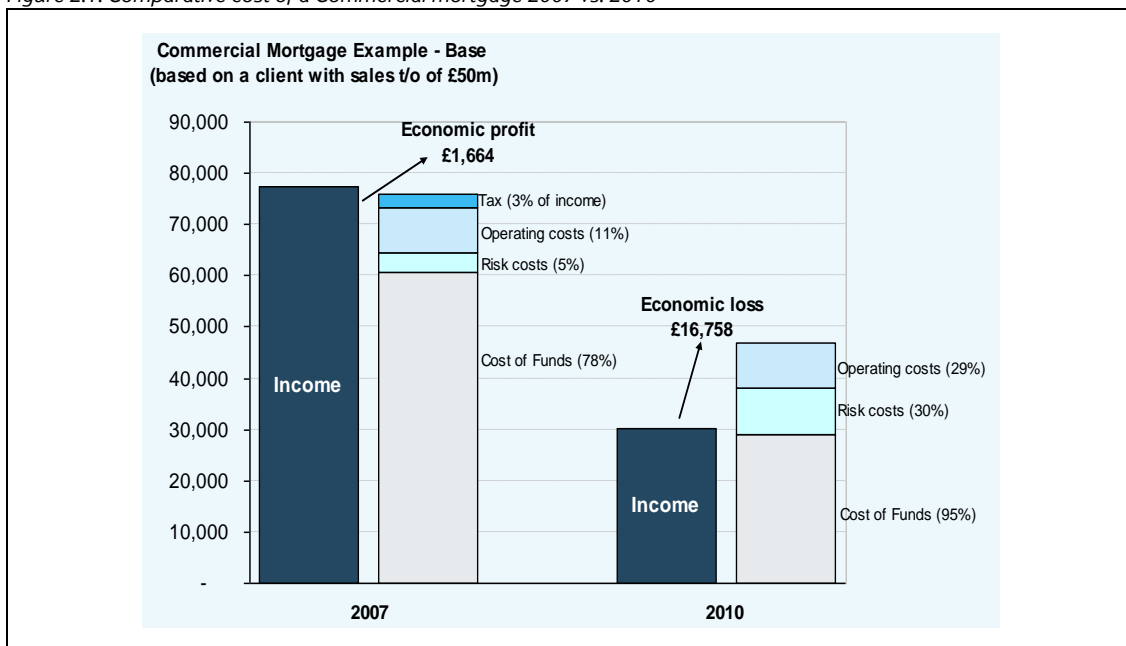
#### **The pricing of a loan is heavily influenced by funding, capital and estimated default costs**

- 2.20 A number of components contribute to the price of, for instance, a loan to a small business customer. Price is, *inter alia*, heavily determined by the cost of funding, including the cost of capital, and risk of default (i.e. risk costs) – illustrated in Figure 2.1. Funds available to banks to lend (obtained via capital, wholesale funding or deposits)

have become scarcer as a result of the crisis and subsequent regulation, whilst the recession has increased the risk of default on loans.

- 2.21 Prior to 2010, funding costs had fallen, to a certain extent as a result of exceptionally low official policy rates and the differential between the Bank of England’s Base Rate and the London Interbank Offer Rate (LIBOR). However, LIBOR has now returned to a level closer to long term averages, while the Bank’s Base Rate remains at an historical low. As banks lengthen their funding durations, to cut reliance on short term money markets, they must pay a term premium over LIBOR. Some banks have seen an increase in their idiosyncratic risk premia due to institutional issues. Regulatory requirements to hold large liquidity buffers also increase the absolute cost of funding for each £ lent to a customer. Therefore, lending reference rates (such as the Bank of England’s Base Rate) are no longer a good indication of funding costs.
- 2.22 Higher regulatory capital ratios mean banks must hold more equity per pound of risk weighted assets – i.e. per loan made to a customer. In addition, due to higher through-the-cycle risk, business lending, particularly to small and medium-sized enterprises, consumes many times more capital per £ of lending than personal mortgages.
- 2.23 Given recent economic conditions, the probability of default (e.g., missed payments on loans) has increased significantly. Falling values for the assets underpinning loans and the general economic situation of debtors has also increased the potential loss if the loan defaults.
- 2.24 All of the above indicate just how sensitive the pricing of credit to individuals and businesses is to the regulatory framework.

Figure 2.1: Comparative cost of a Commercial mortgage 2007 vs. 2010



## **The UK Government will face jurisdictional limitations in implementing some reforms**

- 2.25 The UK is part of the single EU market and subject to its rules. National regulation in Member States must be consistent to avoid infraction proceedings from the EU. In addition, non-compliance with measures designed to facilitate the completion of the internal market would negatively impact the ability of banks based either in the UK, or in other EU Member States, to compete with each other on a cross-border basis.
- 2.26 Under the EU Banking Consolidation Directive and passporting rules, European financial institutions operating through branches in the UK, but headquartered in other parts of the EU, would be unaffected by any unilateral UK action, particularly any action that relates to structural change, and face no restrictions on those parts of their business operating in the UK. This position has direct implications for the Commission's deliberations, as European banks operating with an integrated business model would be able to continue to operate that business model in the UK as well as the rest of Europe even if the UK authorities determined that structural separation, of any kind, were required for UK domiciled institutions.
- 2.27 At the same time, any unilateral action by the UK (absent parallel legislation by the EU and other major jurisdictions, particularly in North America and Asia) may be limited in effect to those elements of the financial system that are subject to English law (or UK law).
- 2.28 For example, the power in the UK Banking Act to transfer foreign property (being property outside the UK and rights and liabilities under foreign law) is untested and it is yet to be seen whether the purported transfer of contracts (such as New York law governed ISDA master agreements) could be enforced. This issue needs to be explored carefully in building resolution plans for cross-border banks, but forcibly changing bank structures would be a crude way to address it.
- 2.29 If the UK unilaterally implements legislation requiring structural separation, there may be similar issues around enforceability of that legislation. The only practical way that we see to mitigate this limitation is for a significant number of foreign jurisdictions to participate in regulatory action of the same nature and on similar implementation timescales.

### 3. Financial stability and competition

- 3.1 Stability measures and the regulatory framework clearly have a significant impact on competition and on the international competitiveness of UK banks.
- 3.2 It is important to ensure, therefore, that the regulatory framework enables a stable banking market with the right incentives in place for conduct of business. Given that a majority of the largest UK banks are international banks, the creation of a level playing field is not only important to the competitiveness of the UK industry, but it will also govern the ability of the UK banks to contribute to the UK economy. Super-equivalent policy measures (by which we mean a situation where an individual regulator applies regional or international regulatory guidelines more strictly or harshly than was intended or was applied by regulators in other jurisdictions) will lead to competitive distortions and will constrain the UK banks' lending, employing, and tax and dividend paying capacity.
- 3.3 For instance, FSA guidance on eligible instruments within a liquidity pool is at variance – in that it is much more restrictive – to the practices of the EU and the FSB. Also, the FSA uses stricter stress tests to assess the liquidity (and capital) position of the banks subject to its supervision, leading to higher capital and liquidity buffers and therefore leading to higher borrowing costs for customers of UK-based institutions.
- 3.4 Barclays has already taken steps to ensure full compliance with the FSA liquidity regime. As a result, our overall cost of funding has increased significantly over the past two years and is now significantly out of line with the equivalent cost for our French, German or US peers. We are required to have a larger liquidity buffer, and the investments into which those funds can be placed are limited to a narrow set of instruments that are low risk and low return (so, therefore, have high cost to carry). To be clear, we believe the direction in which the FSA has travelled is appropriate. The point is that it has travelled there faster and in a more restrictive way than other authorities with direct implications for the ability of UK banks to compete.
- 3.5 Further debate on the interaction between effective competition and financial stability should take place in the EU and international sphere to ensure a level-playing field between UK and non-UK banks.

## 4. Large complex banks and the financial system

### Overview

- 4.1 Banks are typically classified as “universal banks” if they have a broad base of activity across retail and wholesale banking. There is, though, no consistent definition of what precise mix of those activities causes an individual institution to be described as a universal bank.
- 4.2 It is important to note that, within the group of banks that are typically classified as universal banks, the range of actual business models, business mix, and risk profiles is very wide. So any characterisation of them as simply the agglomeration of retail banking and wholesale banking activities is, especially for the purpose of regulatory reform, overly simplistic.
- 4.3 There is some correlation between size and universality given the scale implicit in housing multiple activities within one institution and the need to be competitive in each of those. There is also some correlation with international presence, especially given (i) the more global nature of wholesale clients and markets and (ii) the fact wholesale businesses tend to be particularly scalable.
- 4.4 Universal banks have developed in response to the needs of a diverse set of customers, the nature of international competition and the demands of investors over a long period of time. They have become a feature of the competitive banking systems in all of the major economies around the world, such as the US, Japan, Germany, France, Italy, Canada and Australia. Four of the five major banks in the UK would typically be classified as universal banks. While some have called into question why the UK appears to have such a large proportion of universal banks, the proportion in the UK is, in fact, similar to that in most other G8 (i.e. large, globally interconnected) economies.
- 4.5 The points that follow explore in more detail the benefits we find, from both long and deep experience and direct evidence, that the universal business model can bring to customers, the economy and financial stability, if well-run. The latter qualification should be fundamental to the Commission’s work. It would be easy to construct a list of anecdotal evidence in which universal banks did not provide the stakeholder benefits that we outline below, particularly through the recent crisis. But these represent execution failures within individual institutions, not general issues with the universal banking business model – a similar set of anecdotes could be constructed for any type of bank business model.
- 4.6 We believe the Commission should take the view that the appropriate base of analysis is the fundamental ability of the universal bank business model to create unique benefits. Decisions about the appropriateness of this business model for any individual institution should be left to: supervisors (who need to satisfy themselves that the institution is, in fact, well-run from a prudential perspective); an appropriately competitive market (recognising that, if the Commission finds limitations to this in the UK, those will need to be remedied); and the providers of finance to and owners of the institution (who

continuously form their own judgements about whether or not an institution is both well-run and providing the benefits that is must to justify their investment).

- 4.7 We also consider explicitly the issue of implicit taxpayer subsidies in the context of the “too big to fail” issue.

#### **Universal banks exist to fulfil customer needs**

- 4.8 Universal banks have evolved in response to the product and service requirements of those they serve. They have diverse client and customer bases which have diverse banking and financial services requirements.
- 4.9 There is a strong correlation between the economic and industrial structure of G8 countries and the development of large universal banks.
- 4.10 Broadly speaking, this correlation indicates that larger businesses tend to need the broader and more sophisticated banking services that universal banks typically provide.
- 4.11 In many markets there is a significant, and growing, demand from small and medium enterprise (SME) customers for investment banking products. The level of demand for these products varies by market based on a range of factors, such as: the nature of the economy, especially the role of exports; the prevalence of international sources and uses of cash in SME accounts; and the sophistication of the SME customer base, often driven by the sophistication of their customers. These factors are widely observable in the UK.
- 4.12 The range of customers served by universal banks is broad, and their individual needs differ considerably. As noted above, a wide range of very diverse business models sits under the broad label of ‘universal banks’ as a result. Each variant of the universal bank business model attempts to serve its target clients with a combination of services that it believes affords it a particular advantage.
- 4.13 The retail banking activities of universal banks are usually very well understood as they deal with banking products most people use on a day-to-day basis. People are generally less familiar, however, with wholesale banking activities. It is important, therefore, that banks that undertake such wholesale activities demonstrate proactively the “social usefulness” of those activities.
- 4.14 Barclays recognises the role that banks must play in the economy and takes its obligations to contribute at a social and economic level seriously. We believe that the social utility of a financial institution, like that of any organisation, requires creating explicit value for its various stakeholders: its customers; its employees; the communities in which it operates; taxpayers; and its owners. This includes, for banks, such activities as: providing infrastructural banking services; making markets more efficient and effective, thereby making the economy more efficient; and community investment and social activities. We have critically screened, at the Board level, all of our activities against

this yardstick of 'social utility' to determine that our activities indeed create explicit value for these stakeholders.

- 4.15 The following specific examples help to illustrate the contribution of investment banking activities to society:
- a. Barclays has continued to help individuals secure the mortgages that they need to buy a home by marketing and distributing covered bonds, issued by UK banks and building societies despite the subdued market environment, to European and US investors. This lowers the price of mortgages for household borrowers.
  - b. Barclays helps UK farmers to hedge interest rate and foreign exchange risks in relation to their expansion and its Euro denominated subsidy payments creating financial security and allowing prudent financial budgeting;
  - c. Barclays helped a UK Ministry, the largest purchaser of fuel in the UK, to hedge its fuel price risk and make more informed purchasing decisions in the future by highlighting fuel market trends; and
  - d. Barclays continues to help finance large infrastructure projects like schools or hospitals through providing syndicated loans or infrastructure funds that invest into public private partnerships.
- 4.16 In the UK, universal banks offer a broader range of banking services that are typically more inclusive than those of niche or mono-line providers, directly contributing to UK society. Barclays, for example, offers a basic bank account that has greater functionality than that of most other banks. Few niche providers offer mainstream banking services to the financially excluded.
- 4.17 Universal banks are often able to invest in community support initiatives at a significant scale, such as the support provided by UK universal banks to the community finance sector. For example, Barclays is the leading supporter of this sector; since 2004, we have provided £2.5m of direct financial support and very extensive volunteer support through our staff. In 2009, Barclays announced a new £500,000 package of funding to support third sector lenders to provide better access to affordable credit. Non universal banks can clearly provide similar support, but we believe our scale provides significantly greater impact.
- 4.18 Recognising the diversity of activities and underlying business models, all universal banks – because they comprise retail and wholesale revenue sources – provide five basic functions to their customers and the economy:
- a. Secure domestic and international payment mechanisms, with 730 million non-cash payments carried out by banks around the world every day;
  - b. A safe-keeper of deposits, with more than £6 trillion held in the UK alone;
  - c. The absorption of risk through maturity transformation which allows them to extend credit to individuals and businesses, with more than £500 billion of lending to businesses, and £1 trillion of loans to individuals, in the UK alone;
  - d. Helping governments, corporates and investors manage their risk and raise finance; and

- e. Safeguarding and maintaining financial markets (in particular the supply of continuous liquidity enabling buyers to buy and sellers to sell at all times, including during turbulent market conditions, which has a significant effect on market and, therefore, economic confidence).

4.19 These activities do not necessarily require housing in a single, universal bank nor do banks necessarily have to provide these services to a broad range of customers. The existence of specialised banks, focusing on one particular function (e.g., credit card mono-lines focusing on payments) or one particular customer segment (e.g., banks specialised on retail customers) demonstrates this. In order to satisfy successfully their customers' needs and create social value, universal banks must be able to establish that: their services are valued by their customers; that they create cost and convenience advantages for customers versus the supply of services via a disaggregated industry; and that the risks created by co-habitation are manageable. We would argue that the track record through the actual stress test of the last three years of well-run universal banks is evidence that all of these objectives can be met and maintained even in the most severe conditions.

#### **Universal banks provide direct and measurable benefits to their customers**

4.20 In the first instance, universal banks are able to realise synergies from their business model, especially:

- a. cross-selling of different products creates efficiency synergies for customers;
- b. the ability to use common platforms for different customer segments and products creates cost synergies, which can be passed on to customers;
- c. the holistic view that such banks develop about customers – particularly SMEs and corporate clients – and their risks, as well as the asymmetry of income and impairment cycles of the different businesses, typically allow universal banks to manage the risk inherent in facilitating risk-taking by customers better than mono-lines; and
- d. the flexible way in which they can manage their balance sheet and use debt create capital and funding synergies, which permit more expansive lending activity.

4.21 As a result, universals are able to achieve financial efficiencies which can be passed on to their customers. Universal banks are typically large institutions, given the wide range of products provided and customers served, and this means that major fixed costs (e.g., technology, corporate centre costs) can be allocated over a larger revenue base, allowing well-run universal banks to achieve economies of scale.

4.22 Customers also benefit from doing business with a well-run universal bank in several other ways:

- a. A universal bank is able to provide services throughout the lifecycle of a business customer, from SME start-up to multi-national corporation. There are many such examples at Barclays and other universal banks. This continuity ensures a strong understanding of customer needs and a set of services that support expansion in size and sophistication, for example in international trade.

- b. Customers have the option to purchase a wide range of financial services from a single provider. Barclays believes that offering multiple banking services to its business customers, particularly small businesses and SMEs, offers convenience and value. Universal banks, therefore, offer additional choice to clients, with the improved customisation that can be delivered by longer and wider customer relationship knowledge (see below).
- c. Universal banks have a holistic view of the customer enabling them to provide the customer with the products they need and to develop a more accurate risk view of the customer. This leads to more tailored and more accurately priced services.
- d. The cohabitation of physical and derivative asset classes within a bank is what more and more clients want in a globalising world (in order to help them better manage their risks). We see this as particularly relevant to our UK business clients given the importance of non-UK sales to the UK economy.
- e. Universal banks can be more innovative by putting more investment into product research and development, spending more money on the development of complex IT platforms and leveraging their holistic view of customers across product ranges. The development of Barclays Personal Reserve (our industry-leading personal overdraft proposition) as a direct response to customer feedback is an example. Personal Reserve replaces unauthorised overdrafts with an innovative structure (providing more certainty and flexibility) and reduced charges. Our investment over the past five years in our branch network, with geographic coverage across the UK, is another example. Over that period, we have refurbished over 400 branches and launched flagship branches in locations across the UK, with outstanding feedback from local stakeholders.

4.23 The Office of Fair Trading (OFT) recognised in its recent review of barriers to entry, expansion and exit in retail banking that "the SME sector is not homogenous. It contains a range of businesses, differing by size and sector. Due to this diversity, SME retail banking services are often more bespoke than personal banking services." Universal banks are, therefore, through their broad, integrated service offering, ideally placed to meet the more complex needs of SME customers, providing greater choice, as well as a better understanding of their needs and risks.

4.24 Some of those benefits could be achieved through joint-venturing. We believe, however, that, in practice, there is ample evidence to indicate that such arrangements struggle to deliver these benefits and often create additional risks, because it is more difficult to put the appropriate controls and risk management systems in place.

#### **Well-run universal banks enhance financial stability**

4.25 In addition to fulfilling the needs of customers, well-run universal banks benefit the stability of the financial system and the economy, which are indirect contributions to UK society.

4.26 Well-run universal banks provide a more stable structure than narrower retail and investment banks. This occurs as a result of combining related businesses into one so

that, when there are problems in one area, other areas can compensate. As a result, universal banks:

- a. Typically have a more flexible balance sheet. They can move their capital to areas where they will earn higher returns as the opportunities and market environment changes. Similarly, they can support parts of their business to a certain degree when problems arise.
- b. Earn income from a variety of customers. When one customer segment is underperforming, other types of customers provide alternative income streams.
- c. Typically have a more diverse (and, therefore, stable) funding base. Universal banks typically fund their customer activities through the collection of deposits and wholesale issuance. As a result, they enjoy more confidence in a crisis from wholesale markets and depositors alike.
- d. Tend to have better capital raising capacity than narrow banks. They have a more diverse array of recovery options. And the markets typically view well-run universals as more stable, and their traded equity usually has a lower beta, so the demand for their equity is generally higher than for more narrow banks.

4.27 Combined, these characteristics mean that well-run universal banks are less risky and more resilient than narrow banks.

4.28 Many potential causes for this differentiation have been put forward in the analysis of the crisis. If stability is the problem to be addressed (and it is), it is clear that narrow banking is not the solution. A close look at the banks that have failed reveals that there was no single reason for their failure. The wide range of reasons include:

- a. Short-comings in risk management culture, processes and systems;
- b. Business model and, therefore, risk concentration;
- c. An inappropriate funding model (typically because of an over-reliance on wholesale funds, especially short-term wholesale funds); and
- d. Regulatory failure.

4.29 The universal banking model (especially the coexistence of retail and commercial banking alongside investment banking) was neither the principal nor a proximate cause of the financial crisis.

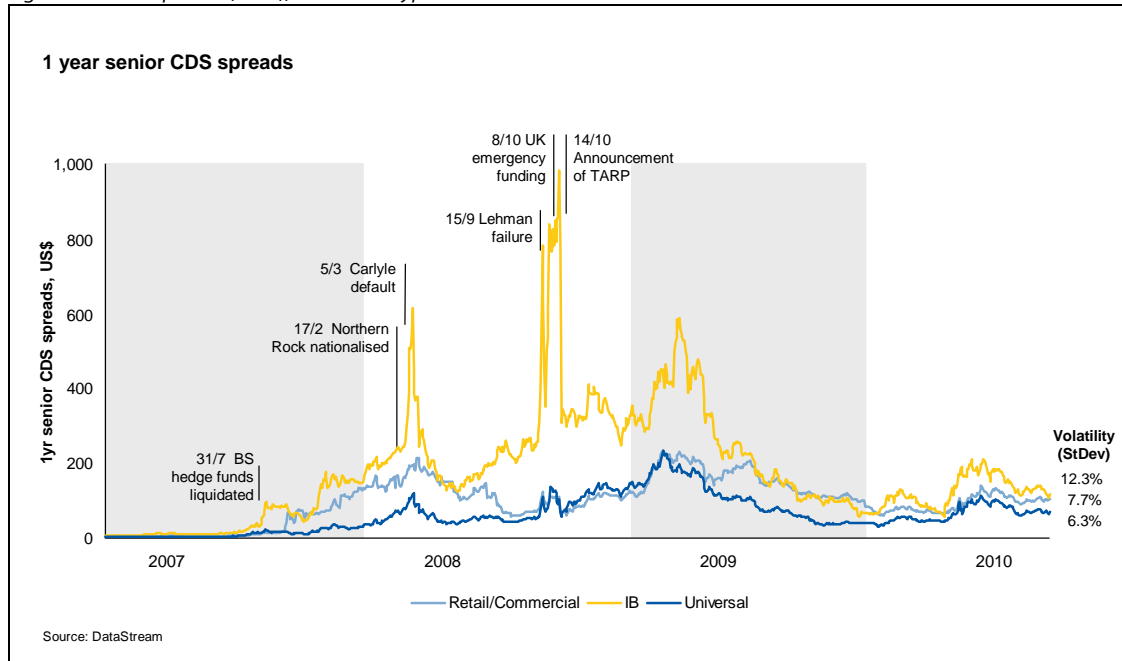
4.30 There were, of course, universal banks that did fail and did need to be bailed out. And it is fair to say that those failures and bail-outs were often large. But it would not be fair to extrapolate from those facts a conclusion that they were directly responsible for, or even contributed significantly to, the systemic aspects of the crisis. And it would be equally unfair to say that those failures were due to the investment banking parts of those universals – it was as often, if not more, the case that the retail and commercial parts of the business prompted the failure.

4.31 Universal banks have more recovery options at their disposal than narrow banks or mono-lines. They can quickly cut costs in their investment banking areas, especially given that compensation is typically a large part of the cost structure and much of it is of

discretionary nature. For the reasons explored above, when an increase in capital is required, universals usually have a much wider range of options available to them.

- 4.32 Although universal banks may be less likely to fail, the cost of their failure could be significant if they are not able to fail in an orderly way, and measures should be taken to ensure that this is not the case.
- 4.33 Retail customers also appreciate the stability offered by well-run universal banks. From the start of the financial crisis in 2007, typically cited as the point when Northern Rock collapsed, through to the height of the crisis in October 2008, Barclays was a net beneficiary of deposits in a flight to quality. This creates a self-reinforcing source of financial stability as this confidence increases the stability of such banks' funding.
- 4.34 History shows that universal banks are more stable, but this does not rule out the possibility that this stability arises from an implicit state guarantee. However, in fact, data from financial markets show that market participants expect universal banks to be less volatile than other models, which again points to inherent stability rather than implicit State guarantee as the cause. For instance, average stock price volatility from 2006-2010 was 3.7 per cent for universals vs. 4.0 per cent for retail and commercial banks or 4.3 per cent for investment banks.
- 4.35 This is also evident in credit-default-swap (CDS) spreads across the different types of banking model (see Figure 4.1). At key points during the crisis, universal banks' CDS spreads were significantly less volatile than those for investment banks, and marginally less volatile than retail / commercial banks. In particular, the impact of the Lehman failure on universals' CDS spreads was more similar in magnitude to that of retail / commercial banks than investment banks.

Figure 4.1: CDS spreads for different bank types



4.36 The relative stability – and defensive characteristics at times of stress or volatility – of the universal model will continue to be important over the next few years as banks rebuild their balance sheets. The diversity of income will support re-capitalisation – in 2009, investment banking markets were buoyant; in 2011, retail markets look likely to be more buoyant. Evidence of this phenomenon is also detectable in the periods of 1994-5, 1998, 2001-2 and 2008-9.

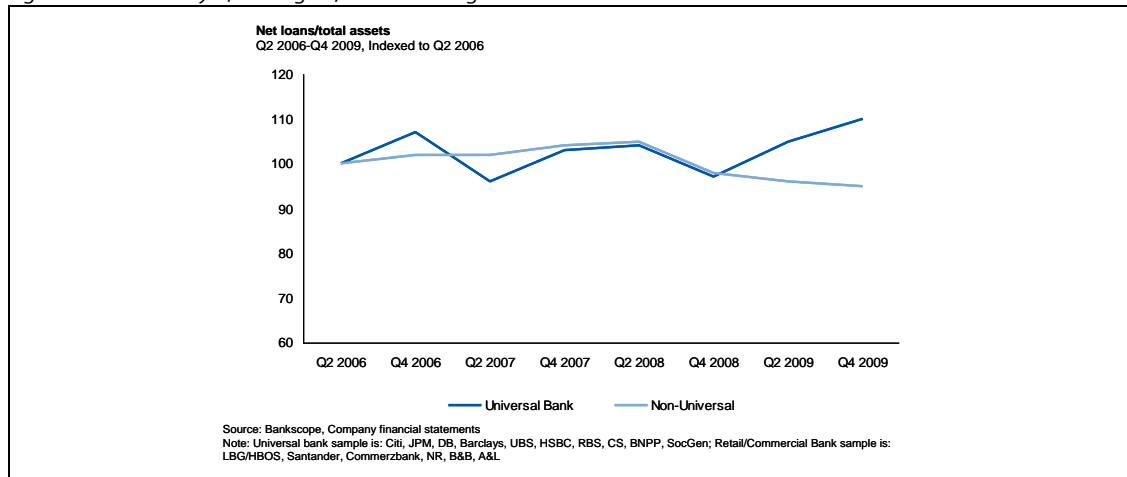
4.37 Some countries with a predominance of banks operating with a universal bank business model – such as Australia and Canada – performed particularly well during the recent crisis. While there were cases of universal banks in difficulty in these countries, the stability of the Australian and Canadian universal banks is further evidence that there is nothing inherently unstable in the model itself, and that other factors (such as weak supervision or poor management or risk cultures) were the more likely issue. The smaller impact of the crisis on Australia’s and Canada’s economies also shows that a stable banking sector, supported by resilient, well-run universal banks, is beneficial to the economy as a whole.

### Universal banks provide significant benefits to the economy

4.38 Universal banks play a pivotal role in the smooth functioning and well being of the economy, providing a wide range of essential services to individuals, SMEs, companies, institutions and governments. They occupy a central place in a complex chain that enables people to buy their home, save for their retirement, pay for goods and services, support entrepreneurs in business start-ups, raise finance for companies and help governments to raise funds to deliver public services and build essential infrastructure.

4.39 At the most practical level, universal banks' greater stability means that they are better able to maintain supply of credit during times of difficulty (see Figure 4.2). This is particularly relevant for small business and SMEs who find it hard to substitute bank lending through capital markets alternatives, but are still essential for economic growth in the UK.

Figure 4.2: Availability of lending before and through the crisis



4.40 The financial services industry in the UK, supported by London's role as a global financial centre, contributes directly to the economy by paying significant amounts of direct and indirect tax and by employing – directly and indirectly – a large number of people. It is responsible for the employment of almost 4 per cent of the UK's working population and contributes more than 10 per cent of total UK tax revenue (with the UK tax take totalling some £61bn in 2009 alone). These figures are dominated by the large cross-border banks headquartered in the UK.

4.41 The UK also enjoys the benefit of a disproportionate share of non-banking professional services, in large part as a result of the strength of London as a financial centre. For example, two of the world's four largest accountancy firms have their global headquarters in the UK, as well as four of the top six law firms. These professional services add nearly twice as much gross value per employee to the economy than the overall average (£60.6k vs. £35.4k). The wholesale arms of UK universal banks play an important role in stimulating the development of and demand for these service businesses, with the attendant job creation and tax yield for the UK economy.

4.42 London's role as a world leading financial centre does not entirely depend, of course, on the strength of the large cross-border banks headquartered in the UK. But we note the general correlation between having strong domestic banks and the contribution of financial services to the economy as a whole.

4.43 This suggests to us that, while it is possible to have a financial centre purely on a hosting basis, this is likely to work better for niche services and is likely to be more vulnerable to flight as the related businesses respond more readily to inducements – such as more

favourable tax treatments – or stress. If UK universal banks were to reduce their role in the wholesale financial markets, London’s predominance as a financial centre might continue for a time on a “hosting” basis. This has been accomplished in other centres, such as Dubai and Dublin. However, the security of London’s position would be much less certain if the UK did not have its own major British participants in the global banking league, particularly in the face of a continued commitment to universality in other major, adjacent economies.

- 4.44 Universal banks help allocate capital efficiently across the national and international economy. They see the full diversity of opportunity for investment – from start-ups, to the world’s largest corporations. They are able to use their knowledge to place capital where it will get the greatest return. Narrower banks have a tendency to trap capital, resulting in a less efficient allocation of capital and lower economic growth. This is a direct corollary of the ‘fire-break’ principle: fire-breaks by their very nature trap capital and create a measure of inefficiency if they are to be effective (a subject which we explore further in Section 7). Strong economies need access to plentiful and patient capital. The universal banks are a principal global source of this vital supply of oxygen to economies.
- 4.45 Finally, it is important to note that the universal banking business model has emerged as a competitive and efficient business model in many advanced economies through competitive market forces, a success that is not tied to the existence of an implicit government guarantee, to which subject we now turn.

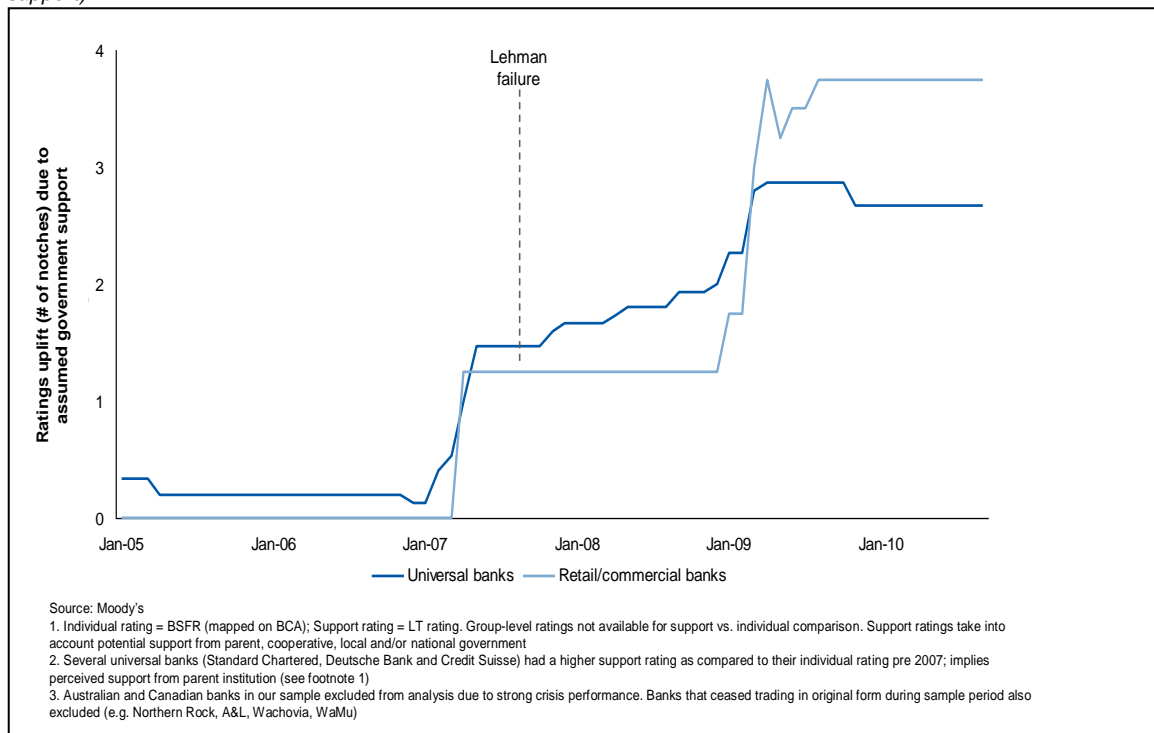
#### **Universal banks are not the beneficiaries of a unique implicit government guarantee**

- 4.46 Some commentators have implied that universal banks are simply a vehicle created to exploit an implicit government guarantee. This logic suggests that, since these institutions are too-big-to-fail, they enjoy lower funding costs and are, therefore, able to grow even bigger because of this market distortion.
- 4.47 As previously noted, the customer benefits that are the underlying reason for the existence of the universal banking model are wide-ranging and material. We find no evidence of any particular guarantee that provides unique benefit to either larger banks generally or universal banks in particular.
- 4.48 The belief that universal banks enjoy an implicit guarantee has its roots in the way in which certain credit rating agencies determine their credit ratings for banks. In recent years, these agencies have begun to differentiate between so-called “stand-alone” and “support” factors to determine the overall creditworthiness of each institution. A certain number of creditworthiness “notches” is ascribed to each. The support notches purport to estimate, among other things, the likelihood of an institution receiving government support if and when it fails.
- 4.49 In the run-up to the crisis, a credit rating agency’s assessment of an institution’s creditworthiness had a critical influence on the market’s perception of that institution’s

viability. Funding costs were, therefore, negatively correlated with credit ratings – i.e. as credit ratings improved, funding costs generally decreased.

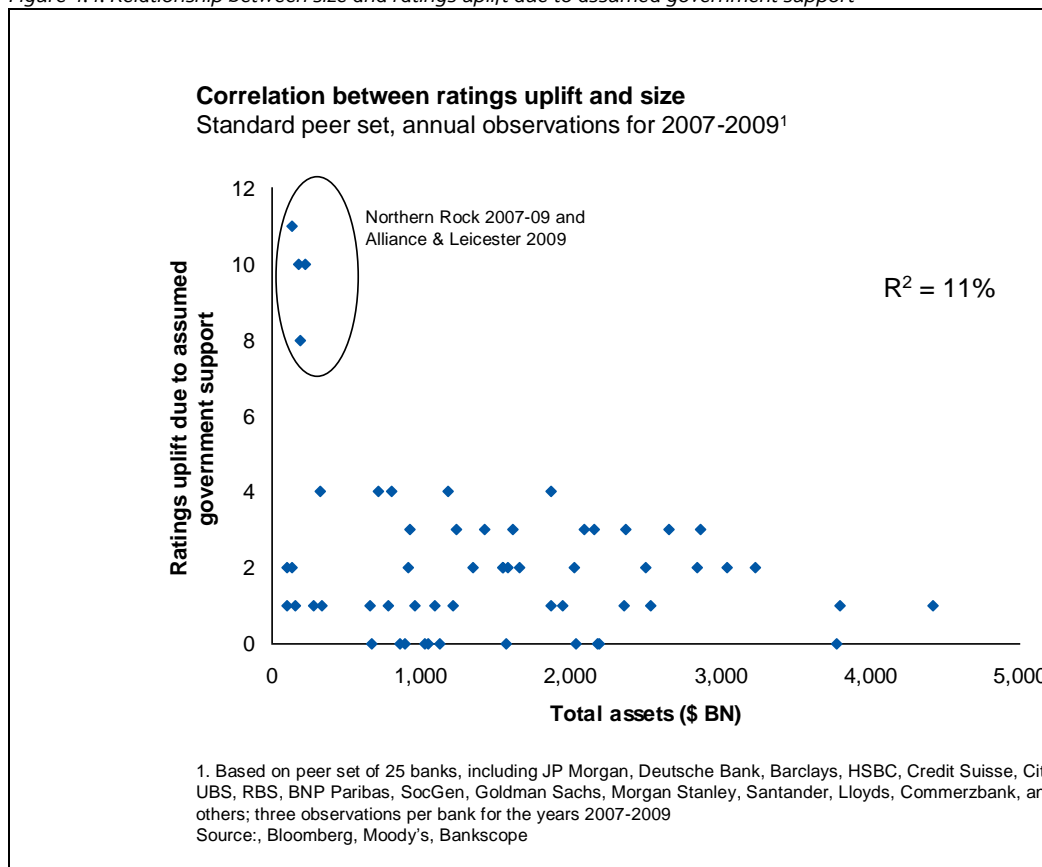
- 4.50 Because specific notches in an institution’s overall credit rating might be designated as support notches, the direct inference is that the funding costs of banks with support notches were being subsidised by an implicit government guarantee.
- 4.51 Research has suggested that the number of support notches which credit rating agencies ascribe to banks is positively correlated with bank size. This implies that there is a direct incentive (in the form of lower funding costs, obtained through an implicit government guarantee) for banks to get bigger.
- 4.52 In fact, an analysis of data from credit rating agencies suggests a different picture.
- 4.53 The difference between stand-alone and support notches only appeared, to any material degree, within the research produced by credit rating agencies to substantiate their ratings in 2006 (see Figure 4.3), by which time the universal banking model had long been a feature of the international and UK banking systems.

Figure 4.3: Difference between individual and support ratings<sup>1,2</sup> by bank type<sup>3</sup> (# rating uplift notches due to assumed government support)



- 4.54 Evidence also suggests that any correlation between support notches and bank size is very weak (see Figure 4.4). The direct evidence from past crises, including the most recent, substantiates this. Historically, banks of all shapes and sizes have periodically, and particularly at times of stress, required direct government support.

Figure 4.4: Relationship between size and ratings uplift due to assumed government support



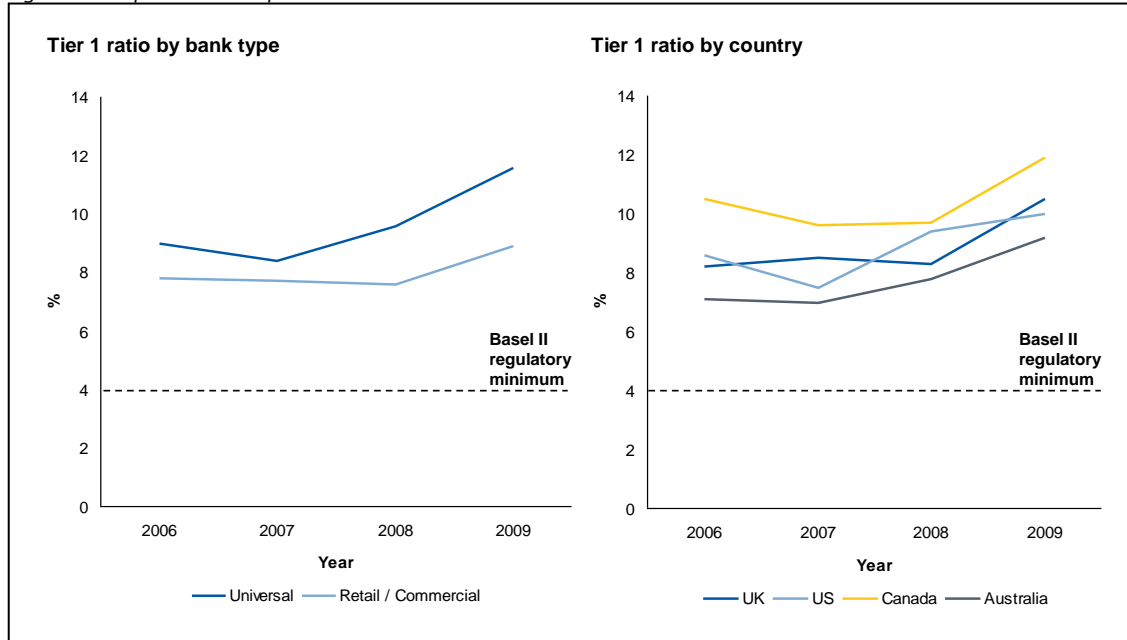
4.55 Although we must avert the need for taxpayer support of the banking system, it is unlikely that we can completely remove the risk of a bank failure. So governments and regulatory authorities must develop powers to intervene. There are two related reasons for that. First, a crisis with its roots in the banking system is a crisis of confidence. Even the orderly failure of an institution can have a materially negative impact on market stability, public confidence and on the economy. Second, such judgements can become, by their very nature, highly political, and it will ultimately be the choice of the State whether or not it wants to rescue a failing institution given the particular circumstances at the time.

4.56 We see this in the evidence that those banks with a particular focus on retail and commercial segments currently have a larger difference between their stand-alone and support ratings than universal banks. This difference arose in 2008/2009, right at the height of the recent crisis. Ultimately, and with almost no exceptions because of the inherent inter-connectedness in financial markets, all banks were deemed too important to fail at the time of the crisis.

4.57 Before the crisis universal banks generally held capital at substantially higher levels than the regulatory minimum required by Basel 2 and above the level held by retail banks (see Figure 4.5). That remains the case today. This suggests that universal banks were managed for safety, and that their business model is not commensurate with the pursuit

of exploiting any form of state support or subsidy. In fact, it turned out in the last crisis that certain banks that failed with narrower business models (e.g., Northern Rock and Bear Stearns) optimized their capital and funding structure to the point of default.

Figure 4.5: Capital ratio comparison

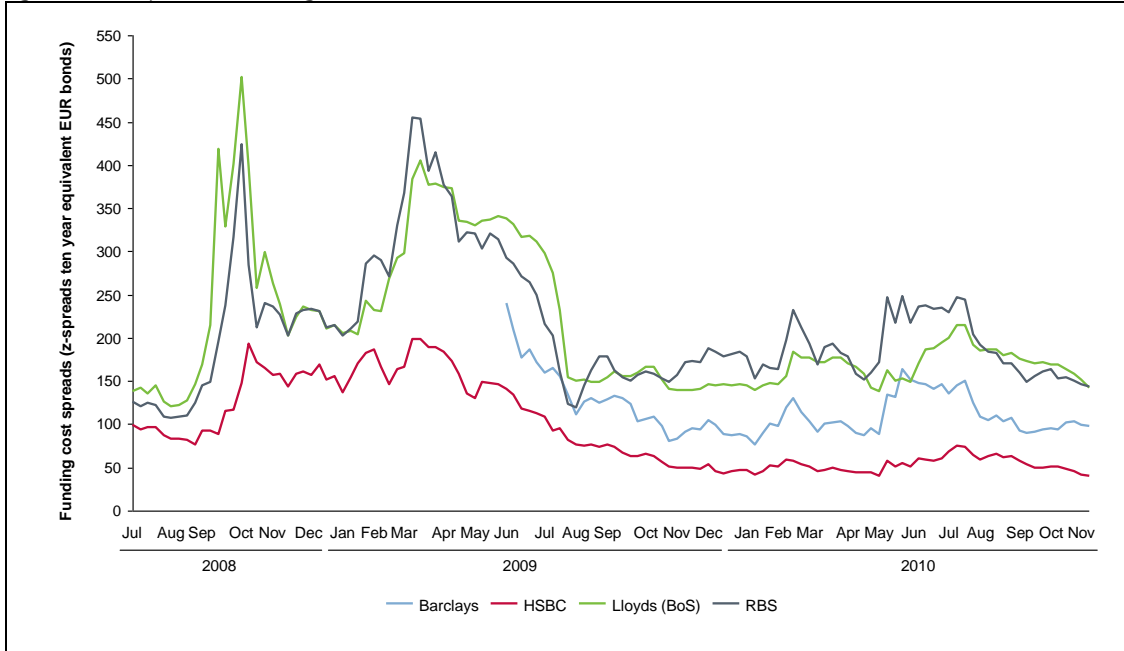


4.58 We agree with the Commission that an explicit or implicit guarantee for individual institutions is undesirable (in contrast to the fundamental role of the government as a lender of last resort for the entire financial system originating from the importance of the financial system to the economy). There are many examples from the past of failed government supported entities that were created with a specific social purpose and an explicit or implicit government guarantee. For instance, in the US, the Federal National Mortgage Association (colloquially known as Fannie Mae or Fannie) and the Federal Home Loan Mortgage Corporation (colloquially known as Freddie Mac or Freddie) were set up to facilitate widespread access to mortgages and enjoyed an implicit guarantee despite being public companies. The German Landesbanken were originally set up to support the *Mittelstand* and enjoyed an explicit government guarantee allowing them to lend at very low prices. This type of government support usually results in excessive risk taking, ineffective risk management and uncompetitive business models. The recent crisis made clear the degree to which Fannie and Freddie had both overextended their balance sheets and to which the Landesbanken had taken on risks beyond their capability to manage when the government guarantee was rescinded by the European Commission, and their business model was exposed as uncompetitive. These, we would suggest, are examples of dangerously narrow banking.

4.59 Finally, we note with particular interest that the market has been inconsistent in its interpretation of whether state support is beneficial. In particular, the evidence suggests that – despite having the explicit support of the UK Government as a shareholder – the cost to RBS and LBG of raising wholesale finance today is actually higher than that cost

for Barclays and HSBC (see Figure 4.6). We interpret this as clear evidence that any belief by the market in a benefit arising from an implicit government guarantee for any institution has been neutered by the recent crisis.

Figure 4.6: Comparison of funding cost for UK banks



## 5. Competition

- 5.1 It is important for the UK that the economy remains strong and healthy and that it is supported by a banking sector which is resilient, but also a banking sector that is independent, competitive and innovative.
- 5.2 Increased competition in recent years has created greater bank efficiency, improved banking services for UK individuals and businesses and precipitated new entry into the market. However, we recognise that, in this context, progress has been negatively impacted by the economic crisis.
- 5.3 Competition agencies have a history of active engagement with the UK banking sector, both nationally and at a European level. There has been no shortage of detailed examinations of the competitive environment in the past. This activity has led to increased transparency and individual choice. We recognise, however, that more could still be done to facilitate greater customer switching, and to address customer inertia and lack of customer understanding for certain products.
- 5.4 In any industry, innovation can be stifled by the cost of compliance with extensive (particularly retrospective) regulatory requirements. That is no less true in the banking market, and may actually be more relevant because of the nature of what banks do and the importance of the safe and effective operation of that to the public interest. 'Retrospection cost' redirects scarce investment funds away from innovation to bring better products and service to market. So we would urge the Commission, if it finds it necessary to make recommendations with regard to competition, to ensure that those recommendations create an environment that is both more competitive and less stifled.
- 5.5 The interests of customers and clients will be protected and enhanced by extensive competition. The prerequisites are: a level playing field; customer choice of bank by shape, size and product offering; and the creation of an environment that is congenial to competition among domestic and foreign players.

### **Market structure has changed materially as a result of the recent crisis**

- 5.6 The market for some products has become more concentrated since the crisis. In particular, the merger of Lloyds TSB and HBOS (to form the Lloyds Banking Group) has resulted in significant further concentration. This was noted by the OFT in its Report to the Secretary of State on the Lloyds/HBOS merger, where it concluded that the merger may lead to a substantial lessening of competition in relation to personal current accounts. This lessening of competition is readily apparent in the market shares set out in the Issues Paper which show Lloyds Banking Group and RBS, the two institutions in which the Government has high shareholdings, as having the highest market shares in current accounts, SME banking services and mortgages.
- 5.7 Two trends are mitigating this increased concentration and could lower it in the medium-term. First, one or two new banks have entered or announced that they intend

to enter the market since the start of the crisis. Second, several banks that took state aid have committed, as a condition of that receipt, to divesting selected assets.

- 5.8 The Commission will need to determine whether to make recommendations about the Government's asset divestment strategy because of the extent to which these holdings impinge on competitiveness. This could create fundamental strategic conflict – the deconstruction of the current enterprises could be competition friendly, but would likely also harm the enterprise value of the Government's (and therefore the taxpayers') stakes.

#### **State Aid needs to be effectively wound down with potential competition implications**

- 5.9 The unique nature of the financial crisis has required numerous special interventions by the authorities and some have distorted the playing field. This intervention was necessary to minimise the impacts of the crisis. European Competition Authorities have made effective interventions to date and need to ensure progress is maintained so the temporary market distortions are removed as soon as possible. The first divestments are now taking place, with the potential to positively impact on the structure of the market.

#### **The regulatory framework needs further development to enhance competition**

- 5.10 Measures which will soon take effect will replace the FSA with a new regulatory architecture for financial services. These present a unique opportunity to ensure that the regulatory framework is one that encourages a competitive market place.
- 5.11 To this end, we agree with the Commission that there is a clear case for the new CPMA to be given a statutory objective to promote effective competition. In addition, we would argue that the Prudential Regulatory Authority and Financial Policy Committee should have regard to the desirability of effective competition when taking decisions or making rules.
- 5.12 Effective communication and consistency of approach between these bodies and existing competition authorities will be essential to ensuring a unified and consistent approach, ultimately to the benefit of consumers.
- 5.13 The CPMA should, for instance, aim to encourage, rather than dilute, appropriate innovation to the benefit of individuals. Any efforts to control product design before testing could impede innovation and competition.

#### **Changes to improve the functioning of consumer markets require careful inspection**

- 5.14 Despite numerous competition investigations and inquiries, some product markets still do not function as well as they could.
- 5.15 In spite of the large number of initiatives already put in place by competition authorities and banks in relation to switching, and to tackle customer inertia, absolute switching levels remain low for certain products. However, absolute switching only provides part of

the picture as many retail customers have a current account with more than one provider (often referred to as “multi-banking”) and the EU Sectoral Inquiry found that UK customers have two current accounts on average. Further work may offer a solution to this issue, which remains a key characteristic of certain retail banking products.

## 6. The case for further reform

- 6.1 As outlined in Section 2, a range of reform measures has been implemented or is in hand to deliver a more secure, stable and resilient financial system. Determining whether any further, UK-specific, reforms are necessary requires careful consideration.
- 6.2 The package of reforms secured in response to the financial crisis has reduced the likelihood of individual institutions failing. For instance, the resilience of UK banks to capital shocks has been very significantly enhanced due to: enhancements to stress testing in the UK; an interim capital regime focused on Core Tier 1; and the introduction of Capital Planning Buffers by the FSA. In addition, the more stringent rules for capital liquidity and leverage represented in the Basel 3 package will materially increase resilience against losses and liquidity shocks.
- 6.3 Basel is also investigating further reforms to create new forms of loss-absorbing capital which would comprise the parts of the Tier 1 capital structure that are not Core Tier 1 capital. This would provide an additional buffer in the event of a capital shock.
- 6.4 Supervision has also been strengthened. In the UK, the FSA has implemented what it describes as a more intrusive approach, enabling supervisory teams to detect issues earlier. The changes to the UK regulatory framework that have recently been agreed are premised on the belief that they will further enhance the UK supervisory framework. Core supervisory colleges have also been established, improving supervision and early detection of problems for more than 30 large and international financial institutions.
- 6.5 Taken together, these measures make the failure of an individual institution considerably less likely. They also significantly reduce the impact of any failure on depositors and taxpayers and much better contain any possible systemic financial risk arising from any institution's failure.
- 6.6 An indirect outcome from the implementation of these measures is an increase in the social utility of banks, as they mitigate the potential value destruction that can result from a financial crisis. Achieving this improvement at a disproportionate economic cost would eliminate any net gain to social utility.
- 6.7 Banking involves the management of risk on behalf of customers and clients and so no bank (large or small) can be made 100 per cent safe, and the failure of any institution cannot be ruled out entirely. Large banks, by the very nature of the services they provide to their customers, are more complex and, in the event of failure, pose a greater potential risk to the financial system. It is, therefore, essential that, in the event of failure, resolution can be achieved in a way that is orderly, without systemic consequences and which does not necessitate taxpayer support.
- 6.8 Determining how to achieve the resolution of banks, particularly those referred to as systemically important financial institutions (SIFI), is of fundamental importance for the international authorities, and many reforms are underway to deliver this. The FSB has

committed to producing more detailed guidance by the middle of 2011. It is critical that the Commission takes these developments and further work directly into account in its analysis.

- 6.9 Barclays strongly supports the creation of consistent resolution regimes, the installation of effective recovery and resolution plans and an increase in the loss-absorbing capital held by institutions.
- 6.10 Of course, the ability of any industry to manufacture goods efficiently for its customers at competitive prices has substantial dependency on input costs. As noted above (2.21 – 2.24), the input costs of the banking industry have been dramatically increased by the reforms of the last two years. For example, relative to the previous minimum Core Tier 1 ratio of 2 per cent (with many banks then running ratios in the range of 3-5 per cent), today's minimum Core Tier 1 ratio is 7 per cent. That figure is struck before (i) the application of the further regulatory and prudential buffers (on which some bank boards may insist) and (ii) the impact of the significant redefinition of Core Tier 1 capital by the Basel authorities. Input costs have, therefore, more than doubled and, for many banks, trebled.
- 6.11 Given the primary objective of facilitating economic growth and creating jobs, the case for further reform needs to take careful account of the cumulative effect of all of these changes on the price and availability of credit.

## 7. Reform options related to the structure of banks

- 7.1 We have given careful consideration to each of the options for reform set out in Section 4 of the Commission's Issues Paper.
- 7.2 One of the options for reform that has been the focus of much public comment is the concept of separating retail banking from investment banking. Barclays welcomes the opportunity to analyse this and other options for structural reform (including measures to be introduced in the US through the implementation of the Dodd-Frank Act) objectively.
- 7.3 Before reviewing our analysis of those options, it is important to note that structural separation can be interpreted in different ways. The simplest demarcation is between so-called "functional subsidiarisation" (leading to some degree of separately capitalised and funded individual business activities within a Group) and "separation" (the construction of new and completely free standing and separate companies). In the analysis that follows, we only selectively distinguish between these two options (functional subsidiarisation and separation) because we believe the benefits and costs that arise from each could be broadly similar. Where we believe the rationale for this position to be important, we have noted it explicitly.
- 7.4 When analysing potential structural reform, we believe the costs, the impact on competitiveness, the implementation risks and the potential unintended consequences of the UK acting alone on each option need to be assessed against the benefits each might create for UK financial stability and competition.
- 7.5 Any analysis of benefits should focus especially on the degree to which each structural reform option contributes materially to the ability of the UK authorities to allow any bank to fail without significant effects on the financial system and the economy as a whole, because we see that as the principal gap that remains to be filled by the international regulatory agenda.
- 7.6 An important driver of both the costs and benefits associated with each structural reform option is the jurisdictional limitation outlined in 2.25 – 2.31. Given these limitations, and in the absence of coordinated European and international regulatory action, any prescribed reform to the structure of UK banks will have significant implications for customers of UK domiciled banks, the competitiveness of UK banks and their contribution to UK society through lending, taxes and jobs.
- 7.7 However, we believe that the structural reforms under consideration have fundamental drawbacks even if these jurisdictional limitations were capable of being addressed. In particular, if we ask ourselves whether the deconstruction of a universal bank (whether through functional subsidiarisation or separation) would address stability, the answer is no. If an investment banking business is to be separated from a universal bank (again, whether through functional subsidiarisation or separation), then it effectively becomes a stand-alone investment bank.

- 7.8 The history of the last three years illustrates the track record of stand-alone investment banks. Even the very best run of these had to change their business models (to allow them to become more universal in nature) to survive the recent crisis.
- 7.9 That history also sheds interesting light on the track record of certain narrow banking models – Northern Rock; Bradford & Bingley; Alliance & Leicester; the Cajas in Spain; and the Landesbanken in mainland Europe. These examples do not point to narrow banking as an effective antidote to systemic instability.
- 7.10 Overall, our analysis shows that any benefits that might be derived from structural reform do not justify the considerable costs and risks. The financial stability objectives in which the Commission has an interest can be achieved more effectively and efficiently through other means – especially the de facto separation of funding sources, and the development of an effective resolution regime and associated tools.

#### **Unilateral action by the UK on bank structure would have significant negative implications**

- 7.11 A unilateral move by the UK would have important and undesirable implications for customers, including:
- a. *Less efficient service:* Customers benefit from the integrated products and services offered by a universal bank, as well as their global reach. In addition to the upfront disruption and operational difficulties in executing the division, separating out the UK parts of banks would require business customers to deal with multiple banks (in the case of a legal separation) and make it harder for banks to develop holistic service offerings for those customers (particularly if businesses within a banking Group were effectively put in “silos” separating either or both specific business activities and UK and non-UK activities). Banks that provide a range of banking services to businesses on a global scale have a better understanding of a business and its performance and so are able more accurately to price risk and provide products and services. We urge the Commission to look carefully at, and provide evidence related to, the effects on customer service in other industries that have been split along the value chain in recent years, as part of its evidence gathering.
  - b. *Higher cost for customers:* Universal banks are able, if they choose, to use their genuine scale and business model scope efficiencies to offer loans and other products to customers at a lower cost. A separation would make it impossible for banks to realise revenue, cost and other financial (e.g., capital, liquidity and risk) synergies. In particular, whether the businesses are functionally subsidised or separated, capital and funding will be effectively trapped as banks would no longer be able to distribute either or both efficiently. In our experience, this could actually have material negative implications for financial stability in the event of a cross-border crisis. This, in turn, would impact the price of products and services provided to customers in the UK, because banks would have to accommodate these costs in order to provide adequate returns to shareholders. How these costs would transmit can be debated, but the fact that they will cannot. There would, of course, be knock-on consequences in the areas of employment, lending, tax and dividends. Again, the

magnitude of those impacts can be debated (because they are difficult to predict, particularly over the long-term), but the fact that they will exist cannot.

- c. *Constrained lending capacity due to increased capital requirements:* Fully separated UK entities would be required to hold more capital in aggregate to operate viable and competitive businesses, because of the elimination of the diversification benefit inherent in the combined business, increasing their cost of capital and funding materially. This would in turn make the cost of credit more expensive and – depending on the timetable of implementation – ultimately reduce lending capacity in the UK. This would be in addition to the effects of the increased capital requirements in the various regulatory reforms already implemented or under consideration.
- d. *Constrained lending capacity due to decreased funding:* Separated or subsidiarised retail banks would find it difficult to expand significantly lending to personal customers. If they were not allowed to securitise assets or use covered bonds as a funding source, deposits would become their main source of funding, recognising a natural limit to their ability to raise senior debt. In such circumstances, the growth of lending to personal customers would be tied to the overall growth rate of deposits in the UK making it more difficult or costly for customers to obtain mortgages or personal loans.
- e. *Unequal treatment of foreign customers:* If only UK deposits are segregated, foreign depositors would not enjoy the same type of protection as UK depositors, as structural reform would remove any benefit they currently perceive in the stabilising factors of a universal bank. That could leave them exposed either to the performance of only the non-UK parts of current UK banks or potentially disproportionately to the wholesale elements of universal banks. Other EU jurisdictions may raise concerns with the Commission about this potential outcome, and customers might understandably decide to take their business elsewhere as a result, which would complicate any implementation and exacerbate any expected impact.

7.12 The general effect of these points is to make it harder for banks to increase their lending. Yet this is a time when, for reasons we understand and accept, UK banks are being urged by the Government to lend more because of the dependency of a private sector led economic recovery on the supply of plentiful credit.

7.13 Under circumstances of unilateral action by the UK, separation would also create important unintended consequences for the competitiveness of UK banks and the financial sector as a whole:

- a. Separation or subsidiarisation would create an unlevel playing field within the financial services industry in the UK and damage competition. It would prevent some banks from competing in specific business activities and would prohibit UK-domiciled banks from realising the synergies of an integrated universal banking model. Foreign banks, particularly those based within the EU, would still be able to compete in all businesses and enjoy the benefits of an integrated business model. In particular, these banks would have a funding cost advantage by using deposits – including UK deposits – to fund a wide range of their activities inside and outside of the UK.

- b. Separation or subsidiarisation would also make UK banks less competitive in many product and geographic markets.
- c. As noted, foreign customers might also take their business elsewhere, further lowering the overall competitiveness and attractiveness of the UK as a financial centre. A substantial part of the global financial business that goes through London today could move away to other financial centres. All of the leading financial centres in the world (New York, Hong Kong, Tokyo) have built their position on the presence of strong domestic banks and equal and fair regulation. If the UK forcibly eliminates the first of these ingredients, London's position could be put in jeopardy.

7.14 Finally, such an outcome is unlikely to improve financial stability in the UK to any material degree, as any risks to financial stability in the non-UK parts of UK banks cannot be addressed through structural reform undertaken by the UK Government in isolation.

7.15 If full structural reform is considered an important reform for the financial sector in the UK, we believe it must be undertaken through international coordination (at the very least on a European level) to avoid the significant negative consequences described above.

**Even without jurisdictional limitations, there are material limitations to structural reform**

7.16 There is little evidence to suggest that any form of structural reform would significantly increase financial stability:

- a. *Increase in reliance on wholesale funding:* Separation or subsidiarisation would – literally or effectively – create stand-alone wholesale banks that would rely exclusively on wholesale funding. Similar investment banking mono-lines played a significant role in the systemic aspects of the recent crisis, especially because of their reliance on short-term wholesale funding. Even in cases where universal banks do not use deposits to directly fund their investment banking business (such as at Barclays), past experience has shown that markets maintain their confidence in institutions with more stable funding sources at a time of crisis. This conclusion directly prompted the focus of the Basel authorities on creating a measure of stable funding and setting out explicit requirements to achieve this. It also prompted the two large, remaining stand-alone investment banks to take on commercial banking licenses in the US so that they could diversify their funding sources. Separation would effectively force investment banks to operate on a less stable funding basis. The likelihood of their failure would increase, and the aggregate stability of the financial system would decrease. The idea that the casting aside of investment banking divisions of universal banks into separately constituted legal entities would add to financial stability because their fortunes could be ignored as systemically irrelevant is, we would suggest, misguided.
- b. *No improvements in resolvability:* Neither separation nor subsidiarisation would materially enhance the ability of the authorities to resolve a failing or failed financial institution without systemic effects. This is particularly true for cross-border institutions. Whether banks are universal, subsidiarised, separated or narrow, an effective resolution regime is necessary to ensure any institution, or significant part

of an institution, can be wound-down in an orderly manner, avoiding systemic effects and any need for taxpayer support. While, in theory, this would enhance depositor protection, the Bank of England, through the Banking Act of 2009, already has the power to affect such separation at the point of non-viability, and the significant work underway with the FSA and the Bank of England on Recovery and Resolution Plans is directed precisely at making that task more feasible than it is today.

- 7.17 The separation of banks on an international scale would decrease the competitive efficiency of the financial system. It would equate to prescribing a specific business model to the market, reducing competitive variety and raising barriers to entry. This would have unpredictable consequences on both competition and financial stability. In many advanced economies, universal banks have emerged as a viable and competitive business model. In fact, the number of mono-lines has decreased over the last twenty years, and such businesses now only represent 47 per cent of all banks (vs. 68 per cent in 1989). This can be attributed both to the fact that many mono-lines have grown to become universal banks in this period, while others have disappeared due to failure of businesses. In other words, market forces often encourage mono-lines either to broaden or to disappear. The success of the universal business model across markets cannot be ascribed simply to the assumption of an implicit government subsidy. Subject to the principle of being well-run and resolvable, it would be more efficient and effective to let markets decide on the most competitive business model within a dependable regulatory framework.
- 7.18 We anticipate important implications of the various structural reform options for the shadow banking sector. With the increase in cost of funding and amount of capital, as outlined above, loans could become more expensive and/or less available. Deposits could become permanently less remunerative for customers because structural reform would, in and of itself, reduce competition for this source of funding (because their use would be limited to specific lending purposes, and they would lose their attractiveness as a stable source of funding to broad banks). These effects are likely to push traditional banking activities outside of the well-regulated banking sector and into the so-called shadow banking sector. For example:
- a. *Corporate lending could be done partially by hedge funds.* As hedge funds will not be subject to the same capital and liquidity requirements as banks, they will be able to offer loans at lower prices to some market segments. While this could be appealing from a competition point of view, the lower level of regulation and the lack of supervision of this market sector will affect the quality of risk management and overall financial stability.
  - b. *Mortgage lending could be done via (closed-end) mutual funds.* However, this takes the underwriting away from banks which tend to have the best information about customers' ability to repay – a key requirement of responsible lending. In addition, the information asymmetry would mean that funds would likely trade at a discount from their net asset value, which would mean a loss of market efficiency.
  - c. *Retail customers could move their deposits to money market funds* in search of higher returns. The withdrawal of money by retail customers from money market

funds in the US – on the realisation that there was no capital or depositor protection associated with these accounts – is widely regarded as one of the factors that destabilised the wholesale markets in general at the peak of the recent crisis.

- 7.19 There could also be implications for the shadow banking sector and financial stability in as yet undefined areas. For example, there is some general agreement that pushing some of the key functions of mortgage lending to the US shadow banking sector (i.e. mortgage brokers) helped cause the US financial bubble and subsequent crisis.

**There would be other unintended consequences and risks associated with separation**

- 7.20 The separation of retail banking from investment banking would involve considerable implementation challenges and risks. For instance, significant legal and operational complexities would immediately arise, including identifying the assets and liabilities affected; transferring them into new legal entities; and (particularly in the case of investment banking) re-negotiating thousands of complex customer contracts. While many of these issues could be practically addressed if the period of implementation were sufficiently long, all the other negative effects explained previously would still make implementation risky and costly. Building an effective resolution plan for a large cross-border bank will require those institutions and the relevant authorities to determine how these issues would be addressed if such banks were to fail, but their forcible separation (through either separation or subsidiarisation) is not necessary to do that.
- 7.21 All of these risks point to the need for a very long transition period if any material structural reform is deemed necessary.

## 8. Recommendations for further consideration

### **A number of measures are being and should be undertaken to promote financial stability**

- 8.1 Effective resolution is critical to making the system safe. Further regulatory reform initiatives are required to achieve the orderly wind-down of failed institutions and to provide a contained solution to bank failure without recourse to Government or taxpayer funds, including:
  - a. improved micro-prudential regulation, including the implementation of the Basel 3 package, enhanced micro-prudential supervision and enhanced stress testing as practised in the UK; and
  - b. better regulatory architecture on a national and international level, comprising the establishment of supervisory colleges and European Systemic Risk Board (EBA) and supervisory authorities as well as the introduction of effective macro-prudential supervision.
- 8.2 Any implicit state subsidy that exists in fact or is presumed to exist by the market for the industry is a distorting factor on competition and can and should be eradicated by more effective arrangements for resolution.
- 8.3 Recovery and Resolution Plans (RRPs) have an important part to play in enabling resolution.
- 8.4 Further work needs to be done to improve market infrastructure and to reduce contagion risk further.
- 8.5 Central counterparties can (if properly capitalised, governed and managed) act as a fire-break – preventing the failure of an individual institution turning into a system-wide crisis. This involves moving standard derivatives clearing to central clearers, thus increasing transparency and reducing counterparty risk. There is currently significant work underway to facilitate this transition across a range of asset classes, and by mid-2011 over 50 per cent of the current OTC derivatives market is expected to be centrally clearable, increasing to around 75 per cent within two to three years.
- 8.6 Work on many of the initiatives outlined here is already underway at an international level. Coordinated international agreement and implementation is vital to avoid distortion of the global competitive landscape.

### **A number of measures could be undertaken to promote effective competition**

- 8.7 Diversity of business model, size and type of bank are strengths of the financial system and of the competitive landscape that should be preserved.
- 8.8 The new UK CPMA should be given a remit to promote effective competition and a duty for both the new PRA and the FPC to have regard to competition when taking regulatory action.

- 8.9 There is an important relationship between financial stability and competition, and there should be an international discussion at the EU and G20 level on the important interrelationship of these two important, but distinct policy objectives and their impact on sustainable global economic growth.
- 8.10 Barriers to entry to the banking market should be kept under constant review in order to ensure that new players who can meet essential prudential requirements are able to enter the market.
- 8.11 Where there are signs of market failure and where business models are unsustainable, appropriate regulatory industry wide measures should be implemented that enable market participants to adjust business models to ensure products and services are provided on a fair, sustainable and competitive basis.

## 9. Conclusion

- 9.1 The Commission's work to promote financial stability and competition is both timely and important. Barclays supports reform to the regulatory system to strengthen financial stability, reduce systemic risk and promote competition.
- 9.2 Governments and regulators should be congratulated on their success in achieving greater financial stability in the wake of the financial crisis. We are confident that there is the global political will to ensure that the further enhancements necessary can be achieved and implemented on a global level.
- 9.3 An optimal outcome, in our view, would be a set of recommendations from the Commission that would enable banks to support economic growth and job creation within a stable regulatory framework that maximises the international competitiveness of the UK as a financial centre.
- 9.4 The issues under consideration by the Commission are complex, and no single reform option, or combination of options, provides a singular solution to the residual risks (after the implementation of all reforms currently underway, under review or under discussion) to financial stability. A package of measures is required to: reduce the probability of financial institutions failing; improve the ability of the relevant authorities to resolve any bank should it fail; and increase competition in the UK banking sector. Much has already been done, but further reform is necessary.
- 9.5 Determining which further reforms should be undertaken will require careful scrutiny against the various objectives set out for the Commission. However, that range of objectives is overlapping and, in some instances, contradictory. The fundamental purpose of banks is to take and manage risk on behalf of their customers in order to support economic growth and job creation. But banks must pursue that objective in a way that delivers those outcomes sustainably, so the banking system must be stable through time. The Commission's recommendations regarding financial stability must, therefore, be optimised to deliver long-term sustainable economic growth and job creation.
- 9.6 There is little empirical evidence to suggest that material structural change (either through separation or subsidisation) would enhance financial stability, not least because the cross border nature of banking risk makes it very difficult for risk to be isolated in, or contained by, national boundaries. The costs of structural change to customers and the wider economy are more certain and high, and the implementation risks are material.
- 9.7 Diversity of business model, size and type of bank is a source of defensive strength in the financial system and of competition. These characteristics should be protected.
- 9.8 The global nature of banking limits the UK authorities' ability to introduce measures that will apply to all banks operating in the UK. Financial institutions domiciled in other EU

Member States would be unaffected by any changes to the structure of banks required by English law. Non-EU banking businesses not subject to English law would be similarly unaffected. Unilateral measures on structural change taken by the UK would, therefore, hamper the international competitiveness of the UK economy without any material commensurate benefit to financial stability.

- 9.9 Efforts to strengthen financial stability further should focus on the orderly resolution of a failing bank. The suite of crisis management and resolution measures currently being explored by the Financial Stability Board is focused precisely on this and will shift the burden of bank failures from taxpayers to financial markets and impose greater market discipline.
- 9.10 The Commission could and should have a significant influence in the area of international conformity by stressing the importance of consistency in both the substance and the implementation timetable of reform.
- 9.11 Some banking markets have become more concentrated through the crisis. National authorities were compelled to make interventions in a number of jurisdictions that resulted in distortions to normal competitive markets. These actions should be reviewed and the necessary steps taken to ensure that effective competition in all banking markets can prevail.
- 9.12 A vibrant, competitive banking sector is a critical ingredient of all strong economies and we welcome measures to enhance further financial services competition in the UK.
- 9.13 In the UK, improvements can and should be made to the regulatory framework for financial services to promote effective competition, and the new Consumer Protection and Markets Authority should be given a statutory objective to promote effective competition.
- 9.14 Barclays stands ready to assist the Commission, the UK government, national and international regulators in any way to help ensure an informed analysis of the issues, costs and benefits of options under consideration.