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Your ref:

Interim Report Feedback
Independent Commission on Banking
Victoria House
Southampton Row
London
WC1B 4AD

Dear Sir or Madam

Independent Commission on Banking (ICB) Interim Report: Consultation on Reform Options

ICAEW is pleased to respond to your request for comments on your consultation paper entitled *Interim report: consultation on reform options*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours faithfully

Ian Michael
Manager, Risk and Regulation
Financial Services Faculty

T +44 (0)20 7920 8412
E ian.michael@icaew.com



ICAEW REPRESENTATION

ICB INTERIM REPORT: CONSULTATION ON REFORM OPTIONS

Memorandum of comment submitted in July 2011 by ICAEW, in response to Independent Commission on Banking consultation paper *Interim report: consultation on reform options* published in April 2011

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the consultation paper *Interim report: consultation on reform options* published by the Independent Commission on Banking.

WHO WE ARE

2. ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, we provide leadership and practical support to over 134,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. We are a founding member of the Global Accounting Alliance with over 775,000 members worldwide.
3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. We ensure these skills are constantly developed, recognised and valued.

MAJOR POINTS

4. We agree with the ICB's objective of maximising the likelihood that banking functions which are essential to the UK economy will be maintained in any future financial crisis without recourse to taxpayer support. We also agree that it is important to minimise market distortions arising from perceptions of possible future public support for banks.
5. ICAEW has considered the possibility of UK retail ring-fencing in some detail. We agree it could make a contribution to addressing the issues noted above. However, it is not a panacea, and a portfolio of policy initiatives is likely to be the most effective, rather than relying on ring-fencing in isolation. It should be borne in mind that in a widespread crisis (such as seen in 2007-09), pressures to provide government support to non-UK retail banking are likely to remain. So continued work on recovery and resolution plans is very important. Moreover, a ring-fence would need to be carefully designed so as to minimise social costs and unintended consequences.
6. The definition of what banking activities must be inside the ring-fence would be crucial. On the assumption that the aim is to protect banking essential to the UK economy for which there is no readily available substitute, the ring-fence would need to encompass more than just retail and SME business. It would also need to include commercial banking – including lending and deposit-taking activities – for corporates, and other entities, below the size and sophistication at which they could realistically source banking services from UK wholesale or overseas banks.
7. The scope of the ring-fence concerns not just deposits but also assets – whether there would be explicit restrictions on the assets which a ring-fenced bank could hold, in order to limit the riskiness of such institutions. The fact that there have been a number of high-profile failures of essentially retail banks around the world in recent years might point in that direction. However, care would be needed in implementing such a policy, because it would not be desirable unduly to constrain some forms of relatively 'risky' lending, such as finance for SMEs. Another issue would be interaction with European Union (EU) rules on banks' right to passport out of their home member state to elsewhere in Europe.
8. Rules on assets could affect returns to ring-fenced banking, and hence interest rates paid to depositors, and returns to investors in bank equity. This could have implications for the market competitiveness of UK banks in the relevant product lines. Were British banks put in an

uncompetitive position, various forms of social detriment could arise. There could be rapid growth of deposit taking by branches of banks from other EU countries – potentially including member states which, in some scenarios, might not have the resources to stand behind their deposit protection schemes. There could also be rapid growth of quasi-deposit taking by UK banks or other firms, for example in the form of money market mutual funds – where the capital value is not protected by the FSCS, but that fact might not be sufficiently appreciated by consumers.

9. Another important issue is whether it would be expected that the funding position of ring-fenced banks could be managed so as to be broadly ‘matched’, or whether they would be likely to be structurally long or short of liquidity. Both of the latter would lead to potential vulnerabilities. The former would lead to counterparty risk in relation to external placement of funds (though this could be mitigated through collateralisation), while the latter would entail dependence on external markets for some funding.
10. Overall, in the light of the points above, we recommend that, in order to inform public debate, the ICB publishes modelling work to explore what the profit or loss, and balance sheet, positions of the ring-fenced banks might look like on different possible definitions of the scope of the ring-fence. This should be accompanied by an analysis of the social, and private, benefits and costs of the different options.
11. We also think that consideration should start to be given to how the transition to a new structure of banking, including ring-fenced entities, might be achieved, not least to highlight legal, tax and operational implications of moving to different types of new structure. An important issue is how far transition – such as moving some depositors’ accounts to ring-fenced entities – would be handled to the extent possible within the framework of existing commercial law, as opposed to bespoke legislation.
12. ICAEW believes that policy initiatives beyond those being led by the ICB also need to be borne in mind. For example, demonstrable progress in putting together credible recovery and resolution plans might reduce the strength of ring-fencing required to meet the ICB’s objectives, and could also reduce the extent of perceived government support to banking business. The same is true to the extent that there is international agreement on additional capital charges for systemically important financial institutions (SIFIs).
13. Other policy initiatives also need to be taken into account in designing an appropriate sequencing for implementing the wide range of reforms agreed, or being contemplated, internationally, in the EU or domestically. It continues to be important to avoid both underlaps and overlaps in regulatory policy initiatives and regarding the responsibilities of different regulatory institutions.

RESPONSES TO SELECTED SPECIFIC QUESTIONS

Q1.1: Do you agree with the general position set out in this *Interim Report*?

14. We broadly agree with the diagnosis in the report of the main problems to be addressed. The events of 2007-08 have highlighted a number of important issues, and the ICB has taken significant steps towards addressing them. However, as explained below, we believe that many of these issues are challenging to resolve. Accordingly, in our view future work should look carefully at the detail of whether particular reforms can be made operational in practice, at possible unintended consequences, and at the balance of social and private costs and benefits.

Q2.1: Do you agree with the analysis set out in Chapter 2?

15. We agree that the case for reform in the UK banking sector, beyond that already put in place or in prospect, should be examined from the standpoint of both financial stability and competition.

16. Regarding financial stability, as the *Interim Report* acknowledges, there is a need to take into account reforms which have been agreed internationally such as Basel III, as well as strengthened prudential rules for banks that have been put in place in the UK by the FSA, dealing for example with minimum capital and liquidity standards for banks. Account also needs to be taken of international initiatives in prospect, such as that of the Financial Stability Board in relation to systemically important financial institutions. But the risks posed by the size of the UK banking system in relation to GDP means that it is right to look at whether there is a need for further initiatives, particularly – as the *Interim Report* argues – to minimise (or ideally eliminate) taxpayer support in any future episode of bank instability.
17. Turning to competition, we agree that there is concentration in much of UK retail banking. Economic theory suggests that this would be likely to confer a degree of market power on the major UK banks, which in turn could lead to higher prices for consumers and/or a lower quality of service.
18. However, achieving a materially more competitive market is likely to prove challenging. On the supply side, there are significant barriers to entry in establishing a new bank, including the need to fund the balance sheet required, to meet regulatory requirements and to achieve brand recognition and contact with consumers.
19. On the demand side, as the *Interim Report* argues, competitive pressure is limited by low rates of switching. That may in part reflect actual or perceived administrative complexities in moving provider. However, even if they were diminished or removed, it may be the case that there are deeper behavioural reasons why consumers are reluctant to change their bank.

Q2.2: Do you agree with the analytical framework?

20. We agree with the objectives of the ICB's work set out in para 2.91, as derived from its terms of reference.
21. We very much agree with the list in para 2.93 of 'complications' in evaluating various possible options for reform. To the extent that the reforms are UK-specific, there is – as noted in the list – an important issue about the extent to which they could cause activities to move outside of UK banks. But that is not to say that such a shift would necessarily be undesirable. If this reflected withdrawal of an implicit public subsidy, it might be socially beneficial, despite private costs to UK banks.
22. We broadly agree with the 'Aims' set out in para 2.95 and with the 'Principles' in para 2.96. However, we believe that the aim of preserving 'capital certainty and liquidity for small savers including SMEs' is described too narrowly.
23. In our view, it is critical that capital certainty is preserved for some retail transactions above the FSCS compensation limit, arising for example out of house purchase or transfers of pension fund pots. It should also be preserved for businesses up to quite a large scale. Only the very largest businesses would be able to have highly diversified bank deposits, because otherwise the amounts involved would be too small to justify the costs of maintaining a large number of individual bank accounts.
24. Particular attention would also need to be given to the treatment of accounts which aggregate essentially retail balances, such as solicitors' and stockbrokers' client money accounts, having regard to levels of protection provided by the Financial Services Compensation Scheme.

Q4.3: Do you agree that bank debt should be made more loss-absorbing using some or all of contingent capital, bail-inable debt and/or depositor preference? If so, which of these tools do you support and how should they be designed?

25. As the *Interim Report* notes, an increase in the loss-absorbing capacity of bank debt would help to reduce the probability of taxpayer support to a bank in difficulty. However, we are not sure how far the methods suggested would work in practice.
26. There are two over-arching issues in this area. One is the desirability of quickly achieving as much certainty as possible regarding the future treatment of the various classes of bank liability under stressed conditions, in view of the large amount of debt which UK and other banks need to refinance in the next few years.
27. Second, a potential difficulty with any kind of debt instrument which incorporates features contingent in some way on the financial condition of a bank is that the triggering of the contingent element could itself be an event which leads to a sharp reduction in confidence in the institution – even if the immediate impact of triggering is to make its position stronger. This may limit the usefulness of contingent instruments in the context of banks as going concerns (i.e. ‘recovery’) – but they may still have an important role to play in the context of bank resolution.
28. Turning specifically to contingent capital, if, as is often envisaged, the trigger for conversion is when a bank falls below a specified regulatory capital ratio, it should be borne in mind that this mechanism would require frequent, accurate measurement – and probably public disclosure – of the relevant ratio. The costs of meeting such an information requirement – and the scope to dispute the measurement following an identified breach – should not be underestimated.
29. But, in any event, while we are aware of some issues of ‘Co-Cos’, market demand is currently largely untested, and may be quite limited. For example, many investors are unable to hold instruments that are capable of being converted into ordinary shares. Furthermore, the cost could be little different to that of ordinary shares, if investor appetite were limited, and given the difficulty of valuing the conversion feature.
30. Regarding bail-inable debt, one class of bank liability – subordinated debt – already has this feature. It is much easier to envisage a world in which banks issue rather more debt which contractually is explicitly bail-inable than one in which some kind of bail-in mechanism is imposed on a variety of types of bank liability. As the *Interim Report* notes, a broad bail-in mechanism would be difficult to apply on a cross-border basis, and the treatment of collateralised liabilities (such as repurchase agreements and OTC derivative liabilities) would pose significant complications. Care would also need to be taken regarding the treatment of netting agreements, and ‘covered bonds’.
31. Depositor preference would achieve some of the objectives of greater loss-absorbing capacity of bank debt, and also of a retail ring-fence. However, it would also presumably be constrained by factors such as collateralisation of liabilities noted in the paragraph above.

Q4.4: In relation to structural reforms to promote stability, do you agree that the ICB should focus its work on a UK retail ring-fence?

32. We think that further work should be undertaken to look at different options for the design of a UK retail ring-fence. One important aspect is the interface with EU requirements, for example relating to free movement of capital and in the Directives which deal with prudential supervision of deposit takers.
33. Our understanding is that the UK retail ring-fence proposal would most notably entail placing the critical economic functions of a UK-based banking group into a separately-capitalised subsidiary (or possibly a set of subsidiaries). This would be subject to more stringent capital standards than the Basel minima. It is possible it would benefit from a

perception of a back-stop government guarantee of its deposit liabilities. However, it would be made clear that the rest of the the UK banking group would not enjoy government support.

34. We agree with the ICB that such a structure would reduce the likelihood of the 'retail' business being brought down by the rest of the group. We also agree that it would not preclude the rest of the group supporting the UK retail operation if it were able (and for UK-headquartered groups, it might be possible to require structuring so as to maximise the scope to support the UK retail operation). In addition, as the *Interim Report* notes, it would probably be easier to recover or resolve a UK retail bank if its activities were not co-mingled with a wider group.
35. Nonetheless, it is important to be clear that UK retail banks would still be 'risky'. Indeed, their focus primarily on one country – the UK – would pose geographical concentration risk. We note that the Building Societies Commission arguably for many years administered a kind of 'UK retail bank' regime for the societies, and there were quite regular failures (which were addressed through amalgamations).
36. The ICB also envisages that ring-fencing would limit perceptions of UK government support for non-UK retail banking. However, we are not sure how far it would be credible to limit the possibility of UK government support just to UK ring-fenced retail banks. The most favourable case for what the ICB has in mind would probably be to decline support to an individual investment banking business in the context of otherwise calm market conditions. To do this if investment banking were under widespread stress, as in 2008, would be more difficult. And failing to support retail banking outside the UK could be more difficult still, because of the direct impact on individual customers and relationships with overseas governments.
37. But, that said, a clear advantage of ring-fencing is that it would provide the authorities with a choice as to whether or not to offer support to banking outside the ring-fence – in contrast to the position in which 'UK retail' and other business are co-mingled on the same balance sheet.

Q4.5: What are the costs and/or benefits of a UK retail ring-fence, and what approaches could be taken to analysing them (noting Annex 3)?

38. As stated in Annex 3, the private costs, to the banks affected, of a UK retail ring-fence would include some loss of diversification benefits and flexibility in management of assets and liabilities across the group as a whole, together with the possibility that the cost of capital and funding for the non-UK retail part of the bank could be higher than now.
39. We agree with the view in Annex 3 that the social cost of a UK ring-fence could be less than these private costs. Higher capital and funding costs for banking outside the 'UK retail' ring-fence would be a reflection of reduction or removal of a public subsidy (the possibility of public support). As the Annex states, the scope for this to lead to price increases in wholesale banking would be limited by the competitive nature of those markets.
40. However, the ICB should consider further what might be the impact of a retail ring-fence on the provision and cost of UK retail and other 'commercial' banking services in the UK. Important factors here include the impact of more stringent capital requirements than the Basel minima; the types of deposit and asset required or permitted to be inside the ring-fence; and the resulting balance between deposit funding and the demand for loans (and other retail / commercial banking products).
41. Another aspect is the operational costs of UK retail banks being required to have the capacity to operate as free-standing companies. These costs may not be small.
42. To take an example from ICAEW's area of expertise, there could be additional accountancy and audit costs, to the extent that there was a demand for UK retail banks to provide fuller annual reports and other forms of financial information than individual components of UK banking groups do at present. And to the extent that more attention is paid to the specifically UK-retail part of a UK banking group, there may be instances where complex accounting

techniques such as hedge accounting would need to be applied to a greater extent than now at the level just of the UK retail bank, as opposed to the group more widely.

43. As the *Interim Report* suggests, the benefits of a ring-fence depend particularly on how far it reduces the probability and/or severity of financial crisis, which is difficult to assess quantitatively.

Q4.6: How should a UK retail ring-fence be designed (noting Annex 7)?

44. The main issues which arise are: (1) ensuring that all of the functions of UK banks which are critical to the UK economy – because there are no readily available substitutes – are inside the ring-fence; (2) the degree of operational separation which would be needed; (3) what ring-fenced banks' balance sheets and profitability might typically look like; (4) minimising the scope to work around the ring-fencing arrangements; and (5) interactions with accounting and public reporting.
45. As regards critical functions, on the assumption that retail ring-fencing were put in place, we can see a case for most of the 'standard services' in figure A7.1 (page 191) being required to be placed inside the ring-fence. That is because most of these functions are ones which society expects to operate without disruption. However, we would not apply this approach to wealth management advice or project finance.
46. But, in addition, close attention would need to be paid to the payments system. This is a critical banking function, but it is not obvious how it could be entirely ring-fenced from the rest of the economy, including investment banking. For example, given the importance of there being no interruption to the ability of firms and individuals to make payments, arguably it would be appropriate for all non-retail accounts used for transaction purposes (particularly sterling accounts) to be permitted – or even required – to be inside the ring-fence.
47. It would also be necessary to specify what cannot be inside the ring-fence. In the absence of this, there might be a tendency for many types of deposit into UK banking groups to be placed in the 'UK retail' entity, so as to benefit from a perception of greater public support.
48. Turning to separation, we agree that, to be worthwhile, 'the ring-fence would need to be strong enough to deliver a material improvement in resolvability and limit contagion from the rest of the group' (page 192). The *Interim Report* focuses particularly on economic separation, such as limiting a UK retail bank's exposure to the rest of its group. But care would also need to be taken with regard to operational separation. If it is envisaged that the UK retail entity would be able to remain fully operational even following the failure of some or all of the rest of its group, it would need to have robust governance capable of incentivising top management of the retail bank to ensure that substantive economic and operational segregation is maintained at all times. It would be necessary for it to have its own staff and premises, and IT systems which could readily be split away from those supporting the rest of the group.
49. Even with very strong ring-fencing, it should be borne in mind that in some scenarios reputational damage could make it very difficult for a UK retail bank to survive the demise of part or all of the rest of its group – even if objectively it was in a financially strong position.
50. One unintended consequence of separation requirements could be to make new entry from outside the EU into UK retail banking harder, as it might be uneconomic for a bank from outside the EU to put such arrangements in place at the outset, when initially it would probably be undertaking only a relatively low volume of business (banks from elsewhere in the EU have the right to 'branch in' to the UK, and would not be affected by UK ring-fencing requirements).
51. We note that the *Interim Report* discussed more stringent regulatory capital requirements for UK retail banks, but there is no reference to other aspects of the regulatory regime – most notably requirements for liquidity.

- 52.** On the question of balance sheet and profitability, we recommend that the ICB publishes modelling work to examine what the balance sheets and profitability of UK retail banks might look like under alternative approaches to implementing a UK retail ring-fence. Such modelling is very relevant to analysing the possible implications for retail banks' business model and financial soundness of different approaches to ring-fencing.
- 53.** For example, it would be important to assess whether UK retail banks would be likely to be long or short of liquidity. One possibility is that depositors exhibit a marked preference to place funds inside the ring-fence, and if these banks' asset choices were constrained, they might need to place funds into the money market – thus creating potentially strong interlinkages with the rest of the financial system. On the other hand, if they were structurally short of liquidity, there is a risk of them becoming dependent on interbank borrowing, which would create vulnerability of a different kind.
- 54.** Another issue is the prospect for UK retail banks' income. It is possible that the regulatory requirements applied to UK retail banks could constrain the interest rates which such banks would be able to pay depositors. That could place UK retail banks in an uncompetitive position with respect to deposit-takers from elsewhere in the EU. The requirements might also lead to a relatively low rate of return on equity. That might in itself be sustainable if such banks evolved business models which the market considered to be low risk, though profitability can be relevant to the ease with which banks can recapitalise themselves following adverse shocks. It could also affect the viability of continuing to provide services such as 'free banking' which to a considerable degree society has come to see as the norm.
- 55.** Account needs to be taken of the fact that, depending on precisely how it is designed and implemented, a retail ring-fence could create incentives for banks to undertake quasi-retail deposit taking outside the ring-fence. For example, banks could market funds structured along the lines of money market mutuals, the liabilities of which would not usually be considered as deposits because they are not contractually capital certain. Amongst other things that could lead to significant consumer detriment because the capital value of investments in such funds is not underpinned by the FSCS. This could have implications for the regulatory perimeter, and the work of regulators on firms' conduct in retail financial markets.
- 56.** Turning to accountancy aspects, we are aware that some commentators have suggested that the business to be placed inside a ring-fence could be defined by the approach taken to measurement of financial assets and liabilities in financial statements. Broadly, instruments measured at amortised cost would fall inside the ring-fence, while those measured at fair value would fall outside it. The downside of such an approach is that there is not a precise mapping between the economic characteristics which should determine what is inside, or outside, the ring-fence and the accounting measurement. However, this lack of precise mapping may be a problem with other approaches to specifying the boundary of the ring-fence, and an accounting basis would have the advantage of being clearly defined. Accounting standards are sometimes subject to significant step changes, and this would present challenges for regulatory approaches based on accounting concepts, so there would be a need for a stable accounting framework.
- 57.** That said, there would certainly be a need for the authorities to consider carefully what form of reporting to supervisors and the public should be undertaken by ring-fenced banks. There is likely to be considerable public interest in the financial condition of these entities, which would point to substantial reporting requirements.

Q4.10: Over what timeframe should any reforms be implemented?

58. This depends in part on the degree of change eventually decided upon. Regarding the broader economic impacts of reform, we agree with those commentators who have noted that structural change can be phased in gradually, thereby taking account of the economic and financial fragilities which exist at present. In any case, significant change, such as a move to retail ring-fencing, would entail numerous legislative and implementation challenges, and would take time to accomplish. Provided the final shape of the reform envisaged is clearly articulated, a reasonably long transitional period could be appropriate, possibly of a length similar to that used for Basel III (which for most aspects runs until 2018).

E ian.michael@icaew.com

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