

Financial Services (Banking Reform) Bill

House of Commons Second Reading – Monday 4 March 2013

The Law Society of England and Wales is the independent professional body, established for solicitors in 1825, that works globally to support and represent its 166,000 members, promoting the highest professional standards and the rule of law

General Points

The Society represents solicitors who have extensive experience of advising financial institutions, businesses of all shapes and sizes and consumers. These measures will therefore directly affect the client base of a number of the Society's members.

The Society has 11,000 member firms, who are predominantly small or medium-sized businesses, but whose members also include a significant number of large international businesses. The banking arrangements, funding and investment options of the Society's members will be directly affected by the proposals.

- Reform of the banking sector should aim to achieve three principle objectives:
 - Enhancing the competitive position of the UK;
 - Increasing the stability of the UK financial system; and
 - Reinforcing the rule of law and remaining consistent with the fundamental legal principles of clarity, certainty and predictability.
- The Bill sets out the broad framework for reform. The precise details of the ring-fence will be set out in secondary legislation. Therefore it is difficult to comment in detail on the impact of the proposals until the secondary legislation has been studied. Based upon the additional detail provided in the White Paper and the response to the Parliamentary Commission on Banking Standards' report the Society has a range of concerns about the current ring-fencing model.
- As presently proposed, a number of aspects of the proposals are likely to reduce competitiveness without noticeably increasing stability in the system and damage the UK's reputation for legal certainty, all potentially resulting in wider negative consequences for the economy. There has been inadequate analysis of the potential impact of the proposed reforms.

The skeleton design of the Bill means that it is vital that secondary legislation is subject to sufficient public consultation and Parliamentary scrutiny

1. The extensive use of secondary legislation increases uncertainty for banks, groups containing banks and consumers as well as inhibiting planning and compliance and increasing the transition costs of the policy.
2. The Society firmly agrees with the recommendation of the Parliamentary Commission on Banking Standards that 'there be a period of three sitting months between the second reading...and the committee stage during which period, in line with the Government's better regulation practice, all of the principle statutory instruments are subject to formal public consultation'.
3. It would be entirely unreasonable to expect Parliament to undertake detailed and informed scrutiny of the Bill without having such consultation responses available to them. As the Parliamentary

Commission noted in its report, 'this would be unacceptable in the case of legislation of such importance'.

The proposed model of ring-fencing is unnecessarily complex and may result in increased costs for banks and their customers

4. The proposed model of ring-fencing will result in a complex set of rules, which cut across important services, which customers (especially business clients), will need. The Bill relies on setting out the prohibitions on what a ring-fenced bank can and cannot do and then might (depending on the secondary legislation) allow a number of detailed and complicated exceptions. The unnecessary complexity of this approach will mean higher compliance costs than alternative ring-fencing models
5. In addition to the complexity, this approach will make it more difficult for the ring-fenced bank to offer some banking services to clients and will result in increased costs for customers. This is likely to have a longer term impact on the competitiveness of banks, primarily in the domestic market but also internationally over time.
6. A clear example of this is derivatives. The skeletal nature of the Bill gives only minimal detail on what, if any, types of derivatives ring-fenced banks will be allowed to offer to their customers. These instruments (e.g. foreign exchange derivatives) are vital to help businesses mitigate the risks of potentially profit-destroying movements in prices. The Parliamentary Commission recommended that ring-fenced banks must be able to offer simple derivatives. The Society agrees.
7. If a bank is unable to offer the services customers need, they will go elsewhere. This includes non-UK banks, not bound by the same rules and restrictions.

The effectiveness of the ring-fence may be undermined by external factors beyond the Government's control and lead to less stability not more

8. The ring-fencing measures in the Bill are subject to important limitations beyond the control of the UK Government. Policy should be made in light of these limits. For example:
 - 8.1. EU single market rules (and other international trade agreements) mean that banks from other Member States will be able to sell retail banking services to UK customers and not be subject to the same ring-fencing regime;
 - 8.2. these EU banks will not face the additional cost of the ring-fence or the restrictions on the types of services they can offer;
 - 8.3. over the long-run, this could lead to significant penetration of the UK retail banking sector by banks from other countries (in particular other EU Member States) EU banks. This could increase systemic risk as banks outside of UK regulatory jurisdiction take larger shares of the UK market and 'import' the risks from other banking sectors.
9. Further complexity and cost will be added if the EU comes forward with its own proposals to split wholesale (investment) banking and retail banking. UK banks could end-up being split three ways. This would have serious additional negative consequences for the competitiveness of UK banks with knock-on effects for associated sectors which supply services to the UK banking industry¹.
10. The ring-fence could also result in increased institutional instability, by narrowing the business model of affected banks, making them less resilient to 'shocks'.

¹ Such as the UK legal sector, which in 2011 generated around £26bn in GVA and £3.6bn in export earnings.

As drafted the reforms may reduce the competitiveness of the retail banking sector

11. There has been insufficient consideration of the possible impact on competition in the retail banking sector or on the wider competitiveness of UK banks. The plans may have the following negative consequences:
 - 11.1. Adverse effects on the incentives to enter the retail banking market and the creation of barriers to expansion by challenger banks. In a sector where competition is often considered inadequate, this would be a counter-productive consequence of the reforms. In particular, the increased costs of doing business, resulting from the ring-fencing policy proposed by the Government, including the higher costs of capital banks may face make it more difficult for any institution that wants to start-up² a new retail bank or expand their existing retail operations (beyond the size threshold where the ring-fence will 'kick-in'). Furthermore, a higher cost of doing business will mean squeezed profitability. A less profitable sector will disincentivise both new entrants and expansion of smaller banks.
 - 11.2. Overly strict credit exposure limits may lead to some banks exiting the retail sector, to merge with other retail banks or to restructure so as to transfer business to subsidiaries elsewhere in the EU.
 - 11.3. Highly restrictive rules governing the activities which ring-fenced banks can carry out could impact negatively on product innovation and product availability, especially for smaller and medium sized businesses;
 - 11.4. Increased costs, coupled with a narrower business model and client base (due to the ring-fencing model envisaged) could impact on the ability of the bank to benefit from economies of scale and scope including the ability to share some back-office operations with the rest of the group. In the medium to long-term this incentivises consolidation. The consequence may therefore be less, rather than more, competition in the sector and job losses and branch closures.
12. EU Single Market rules (and other international trade agreements) will mean an uneven playing field between UK banks and banks in competitor countries. These banks in competitor countries are free to enter the UK retail banking market and offer, from a potentially lower cost base, the comprehensive banking services UK banks might no longer be able to. This could mean a loss of business for UK banks.

Loss-absorbency: bail-in proposals put the UK's reputation for the principle of legal certainty at risk and may substantially raise the cost of capital for banks

13. A primary objective of the Bill is to increase the banks' capacity to absorb losses. One key aspect of this is to establish a so-called 'bail-in' mechanism as part of the regime for stabilising a troubled bank. This means that a troubled bank's bondholders would be asked to forfeit part of their investment to 'bail-in' the bank before taxpayers are called upon to 'bail it out'. Related to this is the proposal for 'depositor preference', essentially putting the safeguarding of savers' deposits first in line to be compensated if a bank fails, at the expense of bondholders.
14. Diluting the position of bondholders in this way risks increasing the cost of capital for ring-fenced banks, as they will likely demand a higher rate of interest to reflect the increased risk. The proposed bail-in mechanism also raises serious questions about legal certainty and freedom of contract; in order to conform with these fundamental legal principles it is vital that investors are clear about the treatment that shareholders and creditors will receive at the time of investment.

² The requirements for establishing a new retail bank are already extensive and require significant resources upfront, both financial and administrative.

15. The widest possible application of bail-in procedures is preferable in order to ensure an international level playing field. It is therefore a matter of concern that the UK proposals are front-running EU-level proposals currently under discussion and more saliently any international agreements. There is the potential for significant complications should two divergent mechanisms emerge.
16. Depositor preference also appears to be an unnecessary overlap when a scheme to protect the vast majority of deposits already exists (and is required to do so by EU law). It could create problems for other creditors, who will now have a reduced chance of succeeding in their claim on the bankrupt banks assets. Victims of this could include SMEs who provide banks with services and who in extremis could be driven into bankruptcy themselves.

The wider consequences of the Bill for support industries have been inadequately assessed

17. The proposals have not been subjected to sufficiently rigorous cost-benefit analysis, especially in relation to the micro-impacts of some of the measures, on important customer groups such as exporting SMEs.
18. The potential wider consequences for support industries, which rely to some extent on a strong banking sector, have not been fully analysed either³.

For further information please contact:

Richard Heinrich (Government and Parliamentary Affairs Unit)

T: 020 7316 5527 / M: 07794 335509

E: Richard.Heinrich@lawsociety.org.uk

³ Notably the legal sector. The close interdependency of the legal and financial services sectors was acknowledged by the Government in a recent publication: MoJ (2011). '*Plan for growth: promoting the UK's legal services sector*', pub: Ministry of Justice: London.