



The Law Society

Independent Commission on Banking: Interim Report
Consultation on Reform Options

Response by the Law Society
of England and Wales
July 2011

supporting
solicitors

Contents

INTRODUCTION.....	1
<i>The stable development of regulatory regimes and absolute clarity as to the rules are important.....</i>	<i>2</i>
<i>The banking crisis is self-evidently not a UK phenomenon, and emphasis should be on "good" law and regulation, rather than narrowly focusing on UK national interests.....</i>	<i>3</i>
<i>Cost-benefit analysis of any recommendations should have close regard to global regulatory developments, and recommendations should be conditional on these developments.....</i>	<i>4</i>
<i>Effects on Competition</i>	<i>4</i>
<i>The Commission's recommendations.....</i>	<i>5</i>
Question 1.1: Do you agree with the general position set out in this Interim Report	6
<i>Capital and Structural Measures</i>	<i>6</i>
<i>Competition Review</i>	<i>7</i>
 THE NEED FOR REFORM	 7
Question 2.1: Do you agree with the analysis set out in Chapter 2?	7
<i>The "Head for the Exits" Phenomenon</i>	<i>8</i>
<i>Loss of UK regulatory oversight</i>	<i>8</i>
Question 2.2: Do you agree with the analytical framework?	9
<i>General</i>	<i>9</i>
<i>Impact on the UK-headquartered banking sector</i>	<i>9</i>
<i>Ensuring a proportionate response in the light of continuing international reforms</i>	<i>9</i>
<i>Cost Benefit Analysis</i>	<i>10</i>
<i>Ring-fencing.....</i>	<i>11</i>
<i>Competition policy intervention.....</i>	<i>12</i>
<i>Impact on existing creditors and the Rule of Law</i>	<i>13</i>
 CURRENT REFORM INITIATIVES.....	 13
Question 3.1: Are there other reform initiatives, beyond those set out in Chapter 3 and Annex 5, which you consider it essential for the Commission to examine further?	13
<i>Capital.....</i>	<i>14</i>
<i>Resolution</i>	<i>15</i>
<i>Shadow Banking</i>	<i>16</i>
<i>Market Infrastructure</i>	<i>16</i>
<i>Reform of Regulatory Institutions</i>	<i>16</i>
 REFORM OPTIONS – FINANCIAL STABILITY	 17
Question 4.1: Should systemically important banks be required to hold more equity than Basel III requirements? If so, how much?	17
Question 4.2: Should UK retail banks be required to hold more equity than Basel III requirements? If so how much?	17
Question 4.3: Do you agree that bank debt should be made more loss-absorbing using some or all of contingent capital, bail-in able debt and/or depositor preference? If so, which of these tools do you support and how should they be designed?	19
<i>Contractual Bail-in.....</i>	<i>19</i>

<i>Statutory Bail-in</i>	20
<i>Depositor Preference</i>	20
Question 4.4: In relation to structural reforms to promote stability, do you agree that the Commission should focus its work on a UK retail ring-fence? .	21
<i>Risk of weakening the UK-headquartered banking sector</i>	21
<i>Risk of a disproportionate response</i>	22
<i>Risk that compartmentalisation leads to increased risk of bank failure</i>	22
Question 4.5: 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)?	23
<i>The risks of the retail banking ring-fence</i>	23
<i>The costs of the retail banking ring-fence</i>	24
Question 4.6: How should a UK retail ring-fence be designed (noting Annex 7)?	25
Question 4.7: Should the Commission pursue any other structural reforms to promote stability?	26
Question 4.8: Do you agree with the Commission's assessment of the impact on the competitiveness of the City and the UK economy of the reforms it is considering? Can you provide further data and analysis in this area?	26
Question 4.9: Do you agree with the Commission's intention to consider a package of measures, and do you think that some elements could be relaxed if others were strengthened?	27
Question 4.10: Over what timeframe should any reforms be implemented?	27
 REFORM OPTIONS – COMPETITION	28
Question 5.1: Do you agree with the three broad measures proposed in this chapter (structural change, improvements to switching and barriers to entry, and pro-competitive financial regulation)?	28
<i>Structural reforms to promote competition</i>	28
<i>Improvements to switching and reductions of barriers to entry</i>	30
<i>Promotion of competition by the FCA</i>	31
Question 5.2: Should the Commission pursue any other measures to promote competition?	31
Question 5.3: What factors make smaller banks more likely to exert competitive pressure on larger incumbents?	32
Question 5.4: Where are the limitations on customers' abilities to understand banking costs, compare different accounts, and switch between them?	32
Question 5.5: What costs might an improved switching process impose on banks and direct debit originators?	33
Question 5.6: How could the costs of meeting prudential requirements be mitigated for small banks and new entrants, while ensuring safe practices in all banks?	33
Question 5.7: How could small banks' ability to offer a national network of cash handling services be improved?	33
Question 5.8: How should the Financial Conduct Authority discharge its duty to promote competition?	34

INTRODUCTION

1. The Law Society is the representative body for over 140,000 solicitors in England and Wales. It negotiates on behalf of the solicitors' profession, lobbies regulators, Government and others. It also works closely with stakeholders to improve access to justice for consumers.
2. The Law Society of England and Wales welcomes the opportunity to engage constructively with the Independent Commission on Banking in their important task, in which they have a considerable responsibility for making recommendations which are beneficial and not damaging to the long term future of the UK economy. It is a difficult task, and we much appreciate the work that the members of the Commission and their staff are carrying out.
3. The Law Society recognises the significant harm done to the UK economy by the recent financial crisis. In order that the impact on the real economy of any future crisis in the banking sector can be limited, the Law Society agrees the need for changes to the pre-crisis regulatory regime. A balanced framework that addresses systematically dangerous situations is required. That is why the Law Society shares the objectives behind the work of the Independent Commission on Banking, that is a stable banking system that can remain robust in the face of further financial shocks, which is prosperous and delivering good value for its customers.
4. The ICB is an important body, entrusted with a vital task. The final recommendations of the Commission could have significant implications for consumers, business in general, the finance sector in particular and of course the UK economy as a whole. Therefore it is crucial they are thoroughly thought through and that they are likely to achieve the stability and robustness objectives set for them.
5. In that light, in this response, the Law Society aims to contribute to the policy deliberations of the ICB to help ensure:
 - ICB policy recommendations will deliver their intended aims.
 - The full range of legal, technical and financial factors, which might impinge on their recommendations are taken fully into account.
 - That key principles such as the rule of law and proportionality are factored into the debate around the reform proposals.
6. In order to ensure our response is as useful, credible and robust in its arguments as possible the Law Society has assembled a highly experienced group of our members (supported by economists) with significant expertise in a range of legal disciplines: EU, banking, competition and financial services law, drawn from major national and international firms to assist in this task.
7. The members of the working group and their firms are listed in Annex 2.
8. This submission concentrates on the issues of policy which arise on which we can bring our knowledge and expertise to bear. It looks beyond the position of UK Regulated banks to wider legal and economic issues, which, we believe, are important to the UK economy as a whole, to the continued popularity of the

UK as a place to do business and to the UK's ability to improve the welfare of its citizens. There are four key themes to the Law Society's comments described below.

The stable development of regulatory regimes and absolute clarity as to the rules are important

9. First, as lawyers we recognise the particular importance of legal certainty, stability and legitimate expectations for businesses of all types and for individuals. This includes a predictable legal framework within which to make business and financial decisions, and confidence that the Government will act in a legal and principled way and respect the rule of law. A vital part of this is robust and effective enforcement when rules are breached. The rule of law and the need for legal predictability are of particular importance in the financial sector, because of the very large sums of money involved and the need for certainty as to the legal basis on which equity and debt are provided to banks. Lack of certainty increases the cost of funding and tends to reduce availability. These effects will inevitably affect not just banks, but their customers and the wider economy.
10. The crisis has made clear the need for regulatory change to address the difficulties experienced and many initiatives are now in progress. We believe that all bodies concerned in the process of regulatory change need to act wisely, recognising that good regulation requires a careful balance of benefits and disadvantages and a co-ordinated approach which takes full account of other initiatives. In deciding upon recommendations to Government, we urge the Commission to have regard to the fact that this wide array of substantial and evolving regulatory changes are bound to have a major impact on a range of stakeholders, not just banks, but their customers and investors, including pension funds, businesses and individuals, with knock-on effects on the wider economy as these changes affect the cost of raising capital and potentially on the availability of capital.
11. In addition to the outcome of the Commission review, banks and their customers will have to adapt to a range of EU and UK regulatory measures, still in the process of evolution, as well as international measures, such as Basel III. Accordingly, there would be merit in there being a coordinated and phased programme of change, including transitional provisions and a frequent review of the interaction of different measures. UK only measures, such as those proposed by the Commission, many need reconsideration in the light of other developments, but the risks of unintended consequences would be much reduced if the Commission's recommendations addressed how their proposals would fit within the other initiatives and, where these remain uncertain as to their final form, whether their conclusions would be affected by the course taken by other measures.
12. If insufficient regard is given to these considerations, then there is a heightened risk of serious adverse consequences. For example, bank shareholders may respond to regulatory risk by not providing the substantial additional equity already required under Basel III. Or they may seek higher returns to compensate for risk, which will adversely affect credit availability and credit prices to the detriment of the UK economy and its international reputation. Regulatory risk will also adversely affect the availability and cost of debt to banks.

13. This is a very fast-moving environment with many initiatives occurring in parallel. Since the Commission's interim report was published, the Basel initiative for tiered capital requirements has emerged and is being hotly debated, the Treasury has published its detailed consultation on UK regulatory reform, and the Chancellor of the Exchequer has announced support for some of the measures proposed in the Commission's interim report, while the EU continues to work on the new EU regulatory structure and on a regime for cross-border resolution, among other initiatives. None of this makes the task of the Commission any easier in reaching its final report, bearing in mind that the stable development of regulatory regimes, coupled with absolute clarity as to the rules (including the detail of how they will be implemented in practice), is important to confidence in financial markets.
14. Accordingly, it would be welcome if the Commission's final report placed its recommendations in their regulatory context, treating the principles of good regulation as a cornerstone underpinning the Commission's recommendations.

The banking crisis is self-evidently not a UK phenomenon, and emphasis should be on "good" law and regulation, rather than narrowly focusing on UK national interests.

15. Second, although the Commission's remit is the UK, the banking crisis is self-evidently not a UK phenomenon and the issues and regulatory solutions are being debated and implemented globally. In this regard, the UK has frequently played a valuable role in international legal/regulatory reviews, with its emphasis being on "good" law and regulation, rather than narrowly focusing on UK national interests. The development of international best practice is particularly relevant in the context of the banking industry because:
 - The failure of banks in, say, the USA would have a major impact on EU and UK banking given the international nature of many banks and as even pure retail banks depend on access to international wholesale banking markets.
 - There is ample scope for regulatory arbitrage, namely financial institutions which are subject to more lax regulation to win market share from rivals which are subject to costly or onerous regulation. This arbitrage can be to the "shadow" banking system (i.e. non-depository banks and other financial entities such as investment banks, hedge funds, and money market funds) and to non-UK regulated depository banks. (Note also that UK regulated banks can choose to relocate to other EU jurisdictions).
 - The impact of a reduced share of banking being provided by UK regulated depository banks may not be viewed as of paramount importance in the short term. However, in the long term it has to be recognised that the UK economy could become more vulnerable to a future downturn: foreign regulated banks could withdraw from the UK economy and their home regulator (as with Iceland) decline to support the failing firm to the extent anticipated. This may therefore lead to a far worse economic outcome in the event of a later financial crisis, with far less control for the UK. Such regulatory arbitrage would therefore both distort competition and compromise regulatory measures aimed at reducing the risk and severity of future banking crises.

16. There would therefore be real merit in the Commission's recommendations aiming for a degree of convergence globally. It may also be legitimate for the Commission to consider scenarios where UK regulation would be more strict than international regulation, and subject them to comprehensive Cost-benefit analysis (CBA), and such CBA should have regard to the points made above as to the adverse consequences of regulatory arbitrage.

Cost-benefit analysis of any recommendations should have close regard to global regulatory developments, and recommendations should be conditional on these developments

17. Third, we welcome the Commission's commitment to arriving at its recommendations using CBA. A key principle of CBA is proportionality, namely that any regulatory measure is proportionate to the detriments it aims to address, and that it the least onerous/costly way of addressing these detriments. By necessity, such assessments must have regard to:
- The internationalisation of developed economies, including that of the UK, must be recognised and that any measures that the UK takes alone must be fully considered within and take account of the international regulatory and legal frameworks within which the UK banks operate, particularly the regulatory measures of the European Union which are directly binding on and/or within the UK. An array of new regulatory measures have already been agreed and are in the process of being implemented, and these additional measures are bound to reduce the incremental benefits of further additional regulation, as well as the risk of such regulation having unintended adverse consequences.
 - The measures which national, European and global regulators are taking in relation to prudential regulation of financial institutions are still evolving and are not all in place. Arriving at definitive proposals may therefore be premature. Accordingly, the Commission should consider whether any of its recommendations should be conditional upon or tailored to the outcome of other regulatory developments.

Effects on Competition

18. We welcome the Commission's concern that regulation in itself may have anti-competitive effects. This is particularly the case in international markets, such as those accessed by businesses, including UK businesses, for commercial finance and investment banking services. In addition, consumers are affected by these distortions where banks exercise passport rights to trade in the UK, as illustrated by the Icesave failure. The OECD in its recent report on Emissions Trading and Competition encapsulated the distortions of competition that occur where there are different regulatory regimes applicable to competitors in the same market.¹

¹ Round table discussion Published 21st June 2006: "**Different conditions in different jurisdictions.** Distortions may also arise due to unequal conditions across jurisdictions that apply to similar firms. Distortions may arise between firms, industries and jurisdictions regulated under the same scheme, there could be distortions between industries in one jurisdiction regulated by means of different policy instruments, or there could be distortions at an international level between countries with different environmental regulations."

19. In proposing UK only recommendations as in the interim report, the Commission risks exacerbating this competitive distortion for affected firms and this needs a detailed consideration and CBA in the final report in relation to each UK-only recommendation. We also believe that the Commission should recommend that any measures it proposes should take place in the context of international and EU consensus wherever possible, so as to minimise competitive distortions.

The Commission's recommendations

20. At the risk of labouring our theme, we consider it particularly important that the Commission's advice to Government is framed with the EU and wider international context in mind and that no recommendations are made for unilateral action by HMG which might be either oppressive or transitory in the light of the way that EU and broader international measures develop. In particular, any requirements for UK regulated banks to restructure themselves further should be approached with caution while the full extent of EU measures remains unclear. This is for a number of reasons:
21. Measures taken unilaterally may be at odds with the EU approach and occasion real damage, not only to the competitiveness of our financial institutions internationally, but to the wider economy: for example a split structure between retail banking and other activities may both increase the cost of capital and reduce the availability of funds to assist in the recovery of the wider UK economy, but leave banks regulated elsewhere unburdened by these costs. EU maximum harmonisation regulation may then force further change, adding to the burden on the UK.
- At present it seems likely that the direct costs of the UK Government bail-out may well be fully covered when the recovering businesses are sold. This could be jeopardised and/or delayed by major restructuring requirements, which seem likely to reduce the return received by Government from those businesses that are to be returned to the private sector.
 - To the extent that non-EU banks operating in the UK might be exposed to these measures (EU regulated Banks would be protected from compliance by their passport rights) this could encourage them to move their activities elsewhere rather than contribute to the recovery of the UK economy. This will not assist in competitiveness within the UK banking sector.
22. We believe that the Commission should not neglect proper consideration of these matters and that it should take the long view in its recommendations to HMG, including recommending that any action should be taken only once the international framework has been established. So far as possible changes should be within the context of the EU regulatory matrix and neither run ahead of it nor be super-equivalent to it.
23. Finally, we believe that it is vital that the Commission's recommendations to HMG reflect the importance of respect for the rule of law and the expectations which individuals, businesses and their investors (including funds that manage the pension funds on which a significant part of the UK population rely) legitimately have that in a civilised society of enjoyment of their property and

legal rights with only essential legal or regulatory intervention. Although there may be a desire to "punish" banks, punishing UK banks specifically and more harshly than required internationally for their part in an international crisis carries a message for all businesses operating in the UK, not just UK regulated banks: the message is that the UK is an uncertain place to do business in, is over-reactive and that there are better and more predictable jurisdictions in which to be headquartered.

24. The fact that the Chancellor of the Exchequer has chosen already to endorse certain of the Commission's preliminary findings, places on the Commission a heavy responsibility to complete its work without a closed mind and to complete and take fully into account a detailed in-context CBA. It should not be deterred from adjusting its recommendations in light of its completed work. Where there are imponderables (e.g. arising from unfinalised EU proposals) that affect the robustness of the conclusions that can be drawn, this should be stated, and affected recommendations made contingent on further review before implementation.

Question 1.1: Do you agree with the general position set out in this Interim Report

25. The Law Society agrees that the recent crisis has created a need for review and reform with the aim of making the banking system more stable and robust in the face of future shocks. There is also a need to ensure the banking system delivers good value for customers through competitive markets. Therefore the Law Society fully supports the objectives of the ICB and it is against that background of similar aims that we make our points.

Capital and Structural Measures

26. Given the interdependence of the global economy and the position of the UK within the European Union, we believe that this has to be considered primarily within the international context, including international measures such as Basel III (implemented through EU regulation) and also the EU prudential and reconstruction measures which are under active consideration. The major international banks for which the UK authorities are lead regulator would be affected not only in the UK but globally by these measures. It would be far better for their future health and for the maintenance of UK regulation of international banks if the measures to which they are exposed are agreed internationally rather than imposed through national measures. In this regard we note that Basel discussions are currently looking at a tiered additional capital requirement of up to 3%. Three of the UK's largest banks, RBS, HSBC and Barclays, would fall in the top tier required to provide an additional 3%. The international debate shows different views on the value of this move. It seems to us that any recommendation in this area will have to take fully account of the outcome of this debate and any move beyond the international consensus reached in Basel will be a potential cause for concern in relation to competitiveness and effect on the UK economy.
27. Accordingly, we do not consider that the Commission is likely to be able within the timescale for its report to make a firm recommendation that HMG unilaterally pursue reconstructive and divestment measures along the lines

proposed or that Banks should be required to increase their capital requirements excess of those required by the EU.

28. We believe that the Commission should concentrate on testing its concerns and then report on the areas in which it considers that the HMG and UK prudential regulators should press for strong measures at Basel and at EU level, bearing in mind that banks regulated in other EU countries are competitors of UK regulated banks and that a level regulatory playing field offers the best chance of long-term and sustainable recovery and competition between those institutions in the modern world. Any UK only measures should be subjected to further CBA in the light of international and EU measures.

Competition Review

29. In the light of the EC Commission's State aid decisions and the fact that the UK banking market is not highly concentrated, we do not consider that another full scale competition review would be appropriate or any specific requirements on Lloyds Bank (which would probably require primary legislation).
30. As regards concerns about switching of personal current accounts, work outside of a competition review on the publicising of competitive measures (cost against income received or foregone) and in minimising the following obstacles would be particularly valuable, taking into account the FSA's practical experience of its recently introduced regulatory requirements relating to the moving of a retail banking service²:
- The need for careful identity checks on taking on a new customer (mostly mandated by money-laundering legislation and informed by the high levels of fraud attempted against the banking system and by identity theft)
 - The fact that moving of direct debits also requires input from the suppliers of the switching customer, not just the two banks involved.
31. A full scale competition review is quasi-adversarial and does not therefore appear to be an ideal forum in which such issues, which have a large technical component, can be constructively addressed.

THE NEED FOR REFORM

Question 2.1: Do you agree with the analysis set out in Chapter 2?

32. Chapter 2 contains the key considerations to be borne in mind in designing a policy response aimed at reducing the impact of bank failures on the UK economy.
33. The Law Society agrees there is a need to take measures which limit the impact of bank failures on the real economy and reduce the risk for consumers. Our arguments aim to ensure that any measures which are brought in are credible, take account of the evolving regulatory environment into which they will have to fit and are measures which will have a good prospect of achieving

² As to which see Rule 5.1.5 of the FSA's Banking: Conduct of Business Sourcebook (BCOBS).

the ends that they are designed to achieve. As part of that approach we would like to highlight two points which, we believe, deserve full consideration as part of the ICB's deliberations:

- The importance of avoiding unnecessary damage to important internationally competitive UK industries; and
- The importance of fostering a robust UK-headquartered banking sector.

The "Head for the Exits" Phenomenon

34. The recent financial crisis has had adverse effects in two different ways. First, the UK taxpayer had to provide direct financial assistance to banks, in the form of capital, liquidity and guarantees. Secondly, as a result of the rapid contraction of credit during the financial crisis, the UK economy suffered a significant loss of output.³
35. At present it appears that the first category of exposure - taxpayer support for banks - may not give rise to any significant fiscal losses. The interventions of 2007 to 2009 are being unwound without loss and there is a reasonable prospect that the taxpayer investments in the banks will be disposed of without loss. However, it is generally accepted that the second category of exposure - loss of output - has resulted in very significant and permanent fiscal losses.
36. This loss of output was, it appears, significantly exacerbated by a "head for the exits" phenomenon relating to foreign-headquartered banking groups. Foreign banks that had previously been active in the UK withdrew to their core domestic lending markets, as underlined by a recent Bank of England paper.⁴
37. It is, therefore, important that the Commission focuses on both sources of loss in designing its policy response. While it is possible to impose capital and structural reforms on UK banks that reduce the likelihood of taxpayer interventions in the future, these reforms would be counter-productive if their effect was to disadvantage UK banks in the UK market and to lead to a relative increase in foreign bank activity in the UK. The effect of such reforms might be to impose greater fiscal and Gross Domestic Product (GDP) losses on the UK taxpayer and economy in a future crisis, as the economy collapses further than it would otherwise have done, as a result of the withdrawal of credit by foreign banking groups.

Loss of UK regulatory oversight

38. The second key reason for fostering a robust UK-headquartered banking sector relates to regulatory oversight. Whether a foreign-headquartered banking group chooses to do business in the United Kingdom through a branch or through a subsidiary, the UK regulatory oversight of the banking group's activity

³ "... the fiscal consequences of banking crises reach far beyond the more immediate bailout costs. These consequences mainly result from the significant adverse impact that the crisis has on government revenues (in nearly all cases) and the fact that in some episodes the fiscal policy reaction to the crisis has also involved substantial fiscal stimulus packages". Carmen M. Reinhart & Kenneth S. Rogoff, *This Time is Different: Eight Centuries of Financial Folly*, Princeton University Press, page 164.

⁴ How did the Crisis in International Funding Markets affect Bank Lending? Balance Sheet Evidence from the United Kingdom, Shekhar Aiyar, Bank of England Working Paper no. 424, April 2011.

is likely to be less complete than in the case of a UK-headquartered banking group. Indeed, in the case of EEA institutions operating in the UK under the European banking passport, the powers of the UK regulatory authorities are severely limited. A policy which gives a competitive advantage to entities operating in the UK in this way, to the disadvantage of the UK-headquartered banking sector, will therefore lead to reduced regulatory oversight by the UK authorities. The Landsbanki and Lehman cases have both demonstrated the risks of relying on foreign regulators and cross-border co-operation in times of crisis.

39. For the reasons set out above, we believe that the analysis set out in Chapter 2 may underestimate the dangers of a policy response that leads to a reduction in the relative importance of the UK-headquartered banking sector in the UK market. Whilst these dangers are alluded to in paragraph 2.32 et seq. and Annex 2 of the Interim Report, the focus of these sections is largely on the migration of banking activity to the shadow banking sector. The migration of activity to the foreign-headquartered banking sector should be of equal if not greater concern.

Question 2.2: Do you agree with the analytical framework?

General

40. We would make three observations about the analytical framework set out in Chapter 2 of the Interim Report.

Impact on the UK-headquartered banking sector

41. The first is that, for the reasons set out in our response to Question 2.1, the impact of the recommendations on the relative importance of the UK-headquartered and foreign-headquartered sectors of UK banking activity should be included in the list in paragraph 2.96.

Ensuring a proportionate response in the light of continuing international reforms

42. The second relates to the need to develop a proportionate policy response in the context of the wider international reform agenda. The issue here is predominantly one of timing. Work is continuing on major international policy reforms that are directly relevant to the assessment of the risks posed by the banking system to the UK taxpayer. This continuing work includes the Financial Stability Board's work on systemically important financial institutions, due to be presented in November 2011; the further development of effective cross-border living wills and colleges of supervisors; and techniques of creditor recapitalisation, including contingent capital and "bail-in", which offer a promising prospect of internalising the costs of bank failure.⁵

⁵ Clifford Chance, *Legal Aspects of Bank Bail-ins*, May 2011. Available at: http://www.cliffordchance.com/publicationviews/2011/05/legal_aspects_ofbankbail-ins.html. See also Institute of International Finance, *Addressing Priority Issues in Cross-Border Resolution* (May 2011). Available at: <http://www.iif.com/regulatory/resolution>

43. Whilst we understand the need for the Commission to report within a defined timetable, it would be regrettable if this drove the Commission to recommend a policy response which proved to be disproportionate in the light of subsequent developments. We would suggest that as a minimum the Commission's final report should note the areas in which further international reforms are under way, and invite the Government to take due account of these before implementing any recommendations from the final report.

Cost Benefit Analysis

44. It is appreciated that the precise causes of the financial crisis are complex and perhaps controversial, but there would be merit in seeking to identify across the array of policy options what aspects/features these options would in fact address and the associated benefits. In addition, the robustness and stability of certain banks, despite the failure and difficulties of competitors, may provide valuable guidance as to effective regulatory measures (for example, did they hold more loss absorbing equity or have better risk management procedures).
45. As noted above, in appraising the costs and benefits of further regulation it is appropriate to consider the incremental benefits and costs of such measures given on-going regulatory developments. In particular,
- Under Basel III, the capital reserves held by banks will increase. This will increase the robustness of banks to losses.
 - Standards of supervision will be enhanced. The Prudential Regulation Authority (PRA) is likely to continue the intensive supervision regime implemented by the FSA following the publication of its detailed audit report on its supervision of Northern Rock in 2008. Under this regime, the FSA more rigorously questions business models and commercial decisions and is prepared to intervene on a forward-looking basis by making judgements about the perceived threat that a given firm could present to its statutory objectives. Indeed it seems clear that this intrusive supervisory approach will only intensify under the PRA, bearing in mind its clear focus on micro-prudential issues.⁶ This should reduce the risk of failure by enhancing effective risk management.
 - Recovery and resolution systems are being developed, so as to ensure that banks are more capable of being restructured and sold in the event of severe market shocks.
46. These regulatory developments and others should make a significant contribution to reducing the risk and severity of future crises. We are not concluding that further measures are not warranted, but the assessment of incremental benefits of further measures should have regard to these on-going regulatory developments. Further regulation is not cost or risk free.
47. CBA also requires the detail of proposals being set out since this affects benefits and costs, with CBA also assisting with the precise specification of further regulation.

⁶ See, for example, the joint paper published by the Bank of England and the FSA in May 2011 setting out how the PRA will approach the delivery of its statutory objective through the establishment of a Proactive Intervention Framework.

Loss absorbing capital – increasing equity, contingent capital (the conversion of debt into equity) and bail-in

48. All three of these measures seek to increase the ability of banks to absorb losses, and thus there would appear to be a degree of substitutability between these measures. In other words, contingent capital and the use of contractual bails-ins could, if deemed effective and desirable on the basis of CBA, reduce the need to increase equity. CBA should inform the choice and balance struck between these alternative policy measures. We discuss the specific options in more detail in response to questions 4.1 to 4.3 below.
49. In short, we believe that further work, taking into account additional factors would be needed to justify proceeding with the Commission's proposed recommendation.

Ring-fencing

50. One of the key benefits identified of a ring-fence "is that it means that the authorities can maintain the continuous provision of retail services through resolution of a smaller and simpler entity"⁷.
51. This ring fencing concept might seem to erroneously endorse the failure of wholesale commercial or investment banks, such as Lehmans, Goldmans and Merrills, when this would undoubtedly have substantial adverse effects on the UK's economy as the major investment banks are important providers of international liquidity. The shadow banking system has a substantial share of lending, having won substantial market share from depository banks.⁸
52. A further complexity is that even a pure retail bank would be exposed to wholesale banks if it borrows or lends to them. In addition, the examples of HBOS, Northern Rock and Bradford & Bingley show that just being a retail bank does not prevent a bank from having a bad business model and becoming insolvent.
53. Where exactly the ring-fence is drawn would affect the risks for business customers and potentially their operating costs: e.g. by limiting the extent to which they can net their exposures. Also the location and robustness of the operational side of a bank may be more important to successful resolution than whether retail and wholesale banking are split.
54. The above points are partially addressed at paragraph 4.81 of the Interim Report in terms of such a ring-fence nevertheless (i) potentially reducing the cost of government bank guarantees; and (ii) limiting disruption. The

⁷ Paragraph 4.63 of the Interim Report.

⁸ For example, a Federal Reserve Bank of New York Staff Report on "Shadow banking", by Pozsar, Z., Adrian, T., Ashcraft, A. and Boesky, H., of July 2010 documents the importance of shadow banks as providers of credit in the United States. The Staff Report finds that there has been a substantial growth in the shadow banking system since the mid-1980s (see Figure 1 of page 5), with the Staff Report finding that in the United States:

- "At the eve of the financial crisis [March 2008 data], the volume of credit intermediated by the shadow banking system was close to \$20 trillion, or nearly twice as large as the volume of credit intermediated by the traditional banking system at roughly \$11 trillion" (page 65); and

- notwithstanding the substantial contraction of the shadow banking system since the start of the financial crisis, "At a size of roughly \$16 trillion in the first quarter of 2010, the shadow banking system remains an important, albeit shrinking source of credit for the real economy", which is still materially larger than the volume of credit intermediated by the traditional banking system at \$13 trillion (pages 5 and 65).

Commission adds that various other measures should address the issues associated with wholesale bank failures. However, the Commission's CBA of any ring-fencing would need to take account of the facts that:

- Measures which reduce the issues associated with wholesale bank failures also reduce the risks associated with universal banking;
- Wholesale banking has a substantial share of international wholesale lending markets, and accordingly the failure of such banks would have severe consequences in any event;
- The potential costs of the implicit government bank guarantee to the UK are significant, but should not be exaggerated. Note also that shareholders have suffered substantially as a consequence of the banking crisis, notwithstanding this implicit guarantee. It should not be assumed that excessive risk taking was without consequence for shareholders; and
- The additional resolution benefits identified by the Commission must also be judged in the light of the FSA's work on resolution (e.g. through the Living Wills programme) and EU measures in the same area.

55. We comment further in response to questions 4.4 to 4.6.

Competition policy intervention

56. The Commission proposes that the Lloyds divestments are further strengthened in order to reduce market concentration and to create a stronger challenger. The Law Society would be concerned if such a remedy were to be imposed on Lloyds without a clear legal basis, such as might (or might not) emerge following a market investigation reference to the Competition Commission albeit that the case for such reference has not been established.
57. As to the merits of the Commission's proposal, it is far from clear that there is a structural competition problem in terms of there being too few rivals; instead any concerns appear to relate to the degree of rivalry between banks. There are two points to be made in this regard:
58. First, there was clearly strong rivalry in the mortgage market pre-crisis, with Northern Rock in particular showing strong growth in market share. However, it is demonstrable that this rivalry was built on an unsustainable business model and that those of Bradford & Bingley and HBOS in the same market also appear to have been suspect. In business banking HBOS also appears to have operated an unsustainable model. Rivalry of this sort cannot be expected to be a feature of reasonably stable markets and this must be taken into account in considering whether the current levels of concentration, coupled with existing divestment plans, which will add to market diversity, should be revised.
59. Second the Commission also queries whether further measures should be imposed to promote switching between banks and whether access to branches for cash/cheque handing is a barrier to entry as regards SME banking. The OFT has recently taken steps to promote switching and a number of the obstacles appear to be of a technical or bureaucratic nature.. These are matters in relation to which further research and consideration would be

warranted, but what is to be done and how should fully take into account the FSA's experience of supervising those requirements of BCOBS aimed at facilitating customer switching between banks. It is not, however, clear why access to branches is a barrier given that there would not appear to be any shortage of suitable outlets capable of providing cash/cheque handing (including vacant retail premises or organisations such as the Post Office). Several large retail chains offer national coverage and, if participating in or contracted to a new entrant, could readily rival the branch network of larger UK banks.

60. We comment further in response to questions 5.1 to 5.8.

Impact on existing creditors and the Rule of Law

61. Finally, we would stress the importance of considering the impact of any proposed policy response on existing creditors of, and non-UK Government investors in, banks and on the rule of law. To the extent that policy responses would require a restructuring of banks or their liabilities, the Commission should take account of the uncertainty that will arise during the transition to the new structure, including the impact on the rights of existing creditors and investors, in deciding whether such responses are desirable. While individual depositors will remain protected by the deposit guarantee scheme, business customers may find themselves dealing with entities with very different risk profiles to that of their existing provider. The potentially adverse effect of resolution regimes on business customers, is a matter that remains on the agenda of the Banking Liaison Panel which advises the Treasury on the Code and subsidiary legislation under the Banking Act 2009.⁹

CURRENT REFORM INITIATIVES

Question 3.1: Are there other reform initiatives, beyond those set out in Chapter 3 and Annex 5, which you consider it essential for the Commission to examine further?

62. There are a significant number of reform measures already in place or in the pipeline. We expect these will increase the robustness and the stability of the banking sector and create a radically changed regulatory environment. These are the context within which the Commission's work will be implemented and we consider that it is vital that the Commission fully addresses in its recommendations the international and EU measures which are under consideration and also understands the EU approach, which is likely to be one of maximum harmonisation¹⁰. Neither Chapter 3 nor Annex 5 deals with the substance of the intensive supervisory regime developed by the FSA (which will be further intensified by the new PRA in a micro-prudential context) or by the way in which the EU Banking Supervisory Authority (EBA) will operate. These will affect both the necessity for and the scope for independent UK action.

63. There is a strong interplay between three factors which we believe the Commission needs to understand in order to determine if additional measures

⁹ Some SMEs fall within the deposit guarantee scheme, but have overall relations with their banks which requires a different approach to that for individuals, while others do not benefit at all.

¹⁰ Maximum harmonisation does not allow divergent action by one Member State.

are necessary and beneficial overall from the perspective of CBA. These three factors are: (i) capital requirements (particularly minimum capital levels); (ii) the supervisory approach adopted by regulators (currently the FSA but soon to be the PRA for micro-prudential issues and the EBA at European level as the relevant supervisory authority); and (iii) the effectiveness of legal measures for recovery and resolution of troubled banks/investment banks.

64. It would be an important contribution for the Commission to bring together these threads and set out for HMG the framework within which their decisions on any possible measures would be made and to consider whether additional measures are needed within that context. In view of what we already know about the FSA's intensive supervisory regime and the anticipated supervisory approach of the PRA, we consider it likely that the bar in relation to factor (ii) will be set at a very high level, partly to compensate concerns regarding minimum capital levels agreed at international level in relation to factor (i).
65. We ourselves are inclined to think that the correct conclusion in considering the cumulative outcome of (i), (ii) and (iii) is such that the Commission must present compelling CBA that additional measures (such as retail bank ring-fencing) are required and desirable. However, if the Commission were to end up with a conclusion that further steps might be needed, there would still need to be a more advanced understanding of the process to be sure that any steps recommended are needed and are not counter-productive.

Capital

66. The Report makes reference to the treatment of capital in Basel III and the required standards for Tier 1 and Tier II instruments: the requirement to write down or convert these instruments to common equity¹¹. However, the UK authorities are unable to take any steps towards the subsequent amendments to the Capital Requirements Directive (CRD 4) until the European Commission has produced its legislative proposals.
67. It is noted that the FSA, in its Business Plan for 2011/12, stated that it would aim to publish a consultation paper on the implementation of CRD 4 in the UK in Q1 2012 with a policy statement to follow in Q3 2012. The FSA will participate in the working group on loss absorbency, common equity, contingent convertible bonds and bail-in debt.
68. It will be essential for the Commission to take account of the work carried out by the FSA in negotiating amendments to CRD4 and preparing for its implementation. The recommendations put forward by the Commission will need to produce practical outcomes which will facilitate implementation. We note that the Chancellor of the Exchequer has indicated agreement with the Commission's provisional view. However we believe that both the reasons and practicality under EU law of going beyond Basel measures requires articulation.

¹¹ Paras 3.6 and 3.7

Resolution

69. The Commission is supportive of UK and international developments to improve the resolvability of financial institutions¹².
70. The FSA started working¹³ with selected institutions in 2010 to produce recovery and resolution plans (RRPs) and, during 2011/12, a key area of work for the FSA will be to pursue the establishment of RRPs for banks.¹⁴
71. The Law Society encourages the Commission to invite the FSA to share the evidence produced by the work already carried out and being carried out by the FSA and the banks.
72. Furthermore, with regard to the special resolution regime provided for by the Banking Act 2009, the Treasury has recently produced a revised Code of Practice pursuant to that Act for the purposes of providing a clear guide to banks and the markets to how the authorities will achieve the special resolution objectives and the powers they may use to do so. The authorities¹⁵ must “have regard” to these statements of policy intention when using their powers.
73. The Treasury is entitled to update the Code on a periodic basis, in “the light of evolving experience”. As above, the Law Society Working Group would support liaison by the Commission with the authorities to explore the experience upon which the Code was produced.
74. There is also now a statutory instrument dealing with a special resolution regime for Investment Banks and seeking to address some of the uncertainties of both the current FSA regulatory approach and the Lehmans litigation¹⁶, although this does not address all the issues that arise on which further work is needed.
75. Much work has been carried out in the UK at “the coal face” of formulating a stable framework for recovery and resolution, and valuable experience gained. It would be unfortunate if the Commission’s recommendations did not build upon this reservoir of timely expertise and make it clear how they do so.
76. Issues relating to relationships between banks and customers with regard to assets such as shares will be affected by EU proposals relating to the rights of holders of intermediated dematerialised securities. These will affect not only those banks that act as intermediaries themselves but also all personal and corporate holders of interests in securities and the operations of clearing and other systems in which such securities are held.¹⁷

¹² Para 3.15

¹³ In furtherance of an obligation placed upon it by Section 7 of the Financial Services Act 2010

¹⁴ In DP10/4, the FSA stated that it intended to publish a Consultation Paper on RRPs in December 2010. This has not yet been published although we note a Feedback Statement to DP10/4 is due during the second quarter of 2011. FSA February Board Minutes reveal that the structure and content of the proposed Consultation Paper has been agreed by the FSA Board and that it is due to be published shortly after a PRA launch document.

¹⁵ The FSA, The Bank of England and HMT.

¹⁶ As the Lehman's litigation resolves and EU legislation develops there will be further changes in this area.

¹⁷ See EU Commission consultation paper on legal certainty in relation to securities holdings and dispositions and responses available on the Europa website.

Shadow Banking

77. The FSA is currently undertaking work with the Financial Stability Board (FSB) in relation to assessing the scope for work in the shadow banking sector and developing potential monitoring frameworks and regulatory measures. This is a key issue for the FSA who will be seeking to establish to what extent and how other parts of the financial system take on risks arising as regulators seek to raise capital standards, limit maturity transformation¹⁸ and control risk-taking by banks.
78. The FSA, and other regulators, will be working to define the nature and scope of shadow banking more precisely; develop a shadow banking monitoring regime and develop a range of policy options to mitigate financial stability risks from the shadow banking sector.
79. Adair Turner has observed¹⁹ that there is a requirement to avoid exclusive focus on individual banks or, even, on the whole banking sector. This should be addressed by assessing the potential risks posed by shadow banking entities, total financial systems and markets. The risks of regulatory arbitrage and migration of risk to less regulated pockets of the markets is worthy of the Commission's consideration to a greater extent than appears in the Interim Report. Furthermore, the Commission should be mindful of the impact any recommendations it may make might have on this trend. This emphasises the importance of working within the EU framework that is addressing all these areas.

Market Infrastructure

80. We understand the Commission will not make recommendations in any direct way on current proposals relating to market infrastructure, but we support its consideration of such developments in its deliberations in other areas.
81. The FSA is devoting considerable resource to policy making in this area and is involved in several European and global initiatives. These initiatives and the FSA's involvement might inform aspects of the Commission's recommendations, but its focus should be at European level.

Reform of Regulatory Institutions

82. The PRA is expected to be created by the end of 2012 and will be responsible for supervising the banks and possibly some elements of the shadow banking sector. The Commission's recommendations could have a powerful impact in this regard and the present authorities and the Commission are urged to maintain an evolving dialogue that takes account of the resources and powers that the PRA will have at its disposal and endeavour to formulate recommendations that will have practical effect in this context.

¹⁸ This term is used to describe the activity of a financial intermediary that accepts deposits or investments of one term (usually short) and places those funds with a debtor in another term (usually intermediate or long term).

¹⁹ Lecture to Cass Business School 16th March 2011

83. The Commission's recommendations should seek to enable the PRA in its role in contributing to the promotion of the stability of the UK financial system and its objective to promote the safety and soundness of regulated firms.
84. The Commission should also have regard to the responsibility of the Financial Policy Committee (FPC) for reducing risks to the financial system as a whole and its powers to recommend changes to PRA policies and rules on a "comply or explain" basis. The PRA will be obliged to monitor capital, liquidity and large exposures of the banks it regulates and in executing this, will apply judgement-based supervision.
85. It is therefore imperative that the recommendations of the Commission take account of the future of banking regulation in the UK and ensure that its recommendations are capable of being delivered in this context. It must deliver tools which will enable supervisors, and senior managers of the institutions, they regulate to make judgements based on clear parameters and risk assessment frameworks. The Commission has the advantage of seeing the Treasury's consultation on financial regulation reform and it is to be hoped that the timescale for dealing with the response will allow the Commission to take account of the final structure.²⁰
86. We also think it is necessary for the Commission to take into account the potential impact of the emerging regulatory philosophy at European Union level, as evidenced in the banking context by the recent establishment of the EBA. This is likely to involve increasingly detailed European legislation, greater use of Council Regulations having direct legal effect in Member States without the need for local implementation and increased restrictions on the ability of Member States to adopt super-equivalent local measures which go above and beyond the standards outlined in European legislation. This will almost certainly make it more difficult for individual Member States to adopt local measures that deviate from agreed uniform European standards. The EBA (in common with the other European Supervisory Authorities) is expected to play a significant role in adopting binding technical standards relating to European legislation and ensuring that this legislation is correctly implemented, interpreted and applied by individual Member States. We therefore imagine that, over time, the ability of Member States to add to or deviate from agreed European standards and interpretations will be progressively eroded.

REFORM OPTIONS – FINANCIAL STABILITY

Question 4.1: Should systemically important banks be required to hold more equity than Basel III requirements? If so, how much?

Question 4.2: Should UK retail banks be required to hold more equity than Basel III requirements? If so how much?

87. We address these two questions together.
88. We believe that caution should be applied in considering further whether the UK should "super-charge" Basel III requirements. The latest Basel discussions

²⁰ White Paper, HM Treasury "A new approach to financial regulation: the blueprint for reform" published 16th June 2011 for comment by 8th September.

indicate a tiered approach which would mean that the Commission's provisional recommendations would be applied to the UK's three largest banks, HSBC, RBS and Barclays. In this area, we believe that the Commission should take account of the moving international consensus and seek to make recommendations that can be fulfilled within it if at all possible.

89. The Commission's CBA as regards increasing the ratio of Common Equity Tier 1 (CET1) to risk-weighted assets (RWAs) to 10 per cent is considered in more detail in the Annex 1 to this response. However, a number of points are particularly worthy of emphasis.
- First, the two studies considered by the Commission to assess optimum equity ratios yield very different results as to optimum capital levels (See Figure A3.1). Taking the BIS estimates, this would point to an optimum equity ratio of about 7-10%.
 - To justify a figure at the top end of this range, the Commission advances several arguments. The first of these is that the lower figure of 7% assumes that a crisis costs 19% of GDP in present value terms, which the Commission describes as "extremely conservative" and that a future crisis could be five or more times larger. However, these calculations take no account of an array of other measures which will be implemented which will reduce the probability and severity of failures - the benefits of increasing equity further should take these into account. In addition, CBA should consider the efficacy and cost of alternative measures to reduce the probability or seriousness of bank failures.
 - A common theme across the studies cited by the Commission is that the marginal benefits of increasing equity decline after 7%. This does not mean that further incremental benefits are not worth pursuing, but it does in particular mean that a focus on correctly measuring the incremental costs becomes more important.
 - As the Commission recognises, Basel III requires a further 3.5% of capital (in addition to CET1 capital of 7% of RWAs), with it being likely that loss-absorbing instruments could contribute some or all of this additional capital²¹. (This aggregate level of loss absorbing capital could, of course, meet the Commission's assessment as to the optimum loss absorbing level of capital.)
 - In addition, we do not think that the case that size alone is destabilising is proven and indeed the case against this proposition is considered more credible. What the question really appears to be posing is that some situations may be too big for a single national state of the size of the UK: the reaction to this, in the modern world, we believe is to look to international measures to address situations in which wider support may be needed. The Basel process and the EU regime have many potentially suitable mechanisms.
90. Against the tiered approach now being considered in Basel, the case for any category of systematically important bank being required to hold more equity is not clear. The effect would be that smaller banks would be inherently more risky than larger ones (on the assumption size is a key factor in systemic

²¹ Paragraph 4.39 of the Interim Report.

importance). This would not encourage confidence in smaller banks and make it more difficult for them to operate on a level playing field. Very small institutions (e.g. Dunfermline Building Society) have failed in the recent crisis and have been resolved in a manner that held depositors harmless (just as with the larger institutions, Northern Rock and Bradford & Bingley) while the very large institutions, RBS and Lloyds were dealt with by means of equity injection and other state aid. We are uncertain whether any of them, other than Lloyds and RBS, were systemically important, but the crisis of confidence that would have been occasioned by the precipitate failure of Northern Rock would have had very serious effects on confidence in the UK banking system and economy; also, at the time of Northern Rock, the resolution tools introduced under the Banking Act 2009 to enable more efficient resolution were not yet in place.

91. The most recent failure (of the very small Southsea Mortgage and Investment Company Limited) has, we understand, been carried out on the basis that deposits above the level of the deposit guarantee scheme have not been protected and will be recovered by depositors only to the extent that Southsea pays a dividend on unsecured claims.²² That is the position that should be aimed at in any resolution and depositors should, as in the USA, be educated to understand the extent of their exposure to loss.

Question 4.3: Do you agree that bank debt should be made more loss-absorbing using some or all of contingent capital, bail-in able debt and/or depositor preference? If so, which of these tools do you support and how should they be designed?

Contractual Bail-in

92. We think that there is no objection to the definitions of capital contemplating a class of debt which is convertible into equity on the basis that the investors choose the trigger and the impact on equity. These are commonly called Cocos. While such instruments may be relatively expensive for banks, they do not raise problems of legal uncertainty for holders and are consistent with the rule of law. As regards investor appeal, this should not in principle be an issue, with corporate and government debt being issued with very different risk attributes and terms (covering seniority, security, default provisions and so on).
93. We agree that there are issues associated with contingent capital as identified by the Commission, namely likely investor appetite for such debt, ensuring that the holders of such debt can bear the associated risks, and the application of "trigger points" at which debt would be converted into equity²³. These include the risk of the trigger point being regarded as an event of default, although logically this is not rational if the conversion has addressed the issue of inadequate capital fully.
94. One possible approach to striking the balance between super-charging capital and the use of Cocos – providing that they can be rendered equally effective solutions – would be to set banks a particular target for loss absorption (as informed by CBA) and then allow them some discretion as to how this is achieved in practice. This would enable the banks to adopt solutions which minimise the costs of such measures.

²² See Bank of England News Release of 16th June 2011

²³ Paragraph 4.42 of the Interim Report.

Statutory Bail-in

95. We are concerned that formal right of government or a financial regulator to convert debt into equity (whether limited or not) - which might be called "statutory bail-in" could have adverse effects on the ability of UK regulated banks to raise debt finance or make the cost excessive because of the legal uncertainty created. This would damage their competitiveness and drive them to prefer regulation in jurisdictions without this requirement. This is a good example of a remedy which would be better taken only if there were an international consensus ensuring a level playing field between regulating jurisdictions, at least within the EU. Bail-in (whether contractual or statutory) is being examined in the course of the EU work on cross border resolution for financial groups²⁴ and we believe that is the only forum in which statutory bail-in should be pursued and that it should only be adopted in the context of an EU-wide scheme. The use of such powers, which are in a sense expropriatory, needs to be squared with the ECHR. We do not believe that the USA has taken any powers of this sort.

Depositor Preference

96. EU law requires that individual depositors benefit from an insurance scheme which is in place in the UK and is ultimately funded by the banking industry. It was the choice of the UK Government to safeguard individual depositors at three failed institutions in full, even where their deposits exceeded the maximum insured. We understand most deposits were below the insured level, which has since been raised. This indicates that there should be no need for depositor preference.
97. The UK scheme also extends to certain small companies and we note that in Bradford & Bingley, the UK Government chose to safeguard a wider range of commercial deposits. In Dunfermline, the Bridge Bank was able to arrange transfer on commercial terms to Nationwide Building Society of the entire relationship with a number of customers outside the initially protected class.
98. We do not think that the creation of formal depositor protection in the resolution of any financial institutions would be appropriate. Indeed it would tend to encourage imprudence by commercial depositors, who otherwise can be expected to exert some financial discipline. In addition:
- The costs of bank funding would be increased if there is an over-hanging priority.
 - The existence of depositor preference would make it difficult to conduct a reliable credit analysis and this would be likely to raise borrowing costs for affected banks and their customers.
 - All of these in turn prejudice lending to customers, both individual and corporate, with knock-on effects in the wider economy, both as to availability and cost of funds.

²⁴ EU Commission Communication *An EU Framework for Cross-Border Crisis Management in the Banking Sector* October 2009 and *Consultation on technical details of a possible European crisis management framework* 6/1/2011

- In other words, the exclusive promotion of retail deposits ignores the wider picture. We consider that it is important that the Commission spells out the ways in which giving depositor protection is likely to result in knock-on adverse effects in the wider economy, since this is not widely understood.
99. We believe that, if one of the aims of reform is to remove from banks perceived protections against failure, then it is important that their ordinary creditors are treated in the same way as ordinary creditors of other businesses which may fail: e.g. there appears to be no justification for the unpaid supplier of goods and services to a financial institution being deferred to depositors, when they would not be deferred to (for example) parties who had paid in whole or in part for goods not yet delivered on the failure of a manufacturing company. In principle all unsecured creditors should have the same rights in the insolvency, even if they have collateral protections (such as a deposit guarantee/insurance scheme, which is ultimately separately funded).

Question 4.4: In relation to structural reforms to promote stability, do you agree that the Commission should focus its work on a UK retail ring-fence?

100. We consider that it is premature to try to answer this question. As stated in our answer to Question 2.2, the key challenge for the Commission is to propose a response that is proportionate in all the circumstances and that is not likely to produce unintended consequences. We are concerned, in particular, that:
- The unilateral imposition of a retail ring-fencing requirement on UK banks may, over time, lead to a relative weakening of the role of the UK-headquartered banking sector in the UK economy and an increasing dependence on foreign-headquartered banks.
 - The imposition of a retail ring-fence may not be a proportionate response if other measures, and in particular mechanisms for creditor recapitalisation such as contingent capital, lower the probability of bank failure to a level where the benefits of ring-fencing outweigh the costs.
 - A ring-fence may in itself increase the costs of capital and/or reduce funds available for lending to business and individuals, with knock-on adverse effects for growth in the wider economy.
 - Under some scenarios, the compartmentalisation of a bank into a retail subsidiary and its separate non-retail activities may increase the probability of the failure of both parts of the bank.

Risk of weakening the UK-headquartered banking sector

101. In our response to Question 2.1, we highlight the fact that dependence of the UK economy on foreign-headquartered banks is undesirable. This is because experience shows that foreign-headquartered groups are more likely to withdraw credit to the UK economy during a financial crisis; and because the UK authorities have less oversight of such groups.

102. Our main concern, therefore, about the retail ring-fencing of UK banks is that it will impose additional costs on UK headquartered banks and, over time, may lead to a weakening of the UK-headquartered banking sector and a relative increase in the presence of foreign-headquartered banks. Whilst the short-term risk of a major UK-headquartered banking group moving its domicile abroad and converting its UK activities to those of a branch or subsidiary may be relatively low, the longer term risk of banking activity migrating to foreign-headquartered banks may be higher. This migration may take place in a number of different ways: by the takeover of a UK bank by a foreign bank; by the redomiciliation of a UK bank; or by foreign banks who benefit from the European banking passport increasing their share of UK lending. The powers of the UK to regulate the activities of banks headquartered elsewhere in the EU and third country banks with their lead EU regulator elsewhere in the EU is, of course, severely limited by single market rules.

Risk of a disproportionate response

103. As stated in our response to Question 2.2, work is continuing on major international policy reforms that are directly relevant to the assessment of the risks posed by the banking system to the UK taxpayer. This work includes the FSB's work on systemically important financial institutions, due to be presented in November 2011; the development of effective cross-border living wills and colleges of supervisors; and techniques of creditor recapitalisation, including contingent capital, which offer a promising prospect of internalising the costs of bank failure.
104. Until these international reforms have run their course, it is not possible to assess the proportionality of retail ring-fencing as a response to the issues highlighted in the Interim Report.

Risk that compartmentalisation leads to increased risk of bank failure

105. The structure of banking groups makes it highly unlikely that the retail operation would survive the failure of the non-retail part of the group: typically, all parts of the group will be dependent on the parent company for capital raising; on a single brand; and on a group-wide set of systems and infrastructure.
106. The ring-fencing of retail activities will increase the risk of failure of the banking group. The attempted compartmentalisation of risk will bring a greater likelihood of failure of one of the compartments, because diversification benefits will have been lost and flows of capital and liquidity around the group will have been constrained. The extent to which the risk of failure is increased will depend on the extent of the measures required to implement the separation, as set out in Annex 3 of the Interim Report. For example, the restriction of capital or liquidity transfers, as suggested in paragraphs 9 and 10 of that Annex, will deprive the non-retail part of the group of the stable funding base provided by the deposits available to the retail part. The requirement to enter into separate master netting agreements, as suggested in paragraph 9, will mean that each part of the bank is exposed to loss even where the other part of the bank would have a countervailing position which could otherwise be offset. And as stated in our answer to Question 4.6 below, the imposition of similar restrictions on all UK retail entities is likely to increase the degree to which their failure is synchronised.

107. This increased risk of failure resulting from retail ring-fencing might be acceptable if it brought with it a significantly increased prospect of resolution of the group without fiscal or GDP loss. However, we would suggest that further work is required to establish whether such an improvement in resolution would result, particularly in the case of the major UK banks that are systemically significant. Three points need to be further analysed by the Commission:

- First, the extent to which the prospects of resolving the retail part of the bank have been increased by the separation. The experience of the United States in operating the resolution regime under the Federal Deposit Insurance Act of 1950 is not as relevant as is often assumed. The United States has a relatively unconcentrated and highly domestically focussed banking system, and the overwhelming majority of resolutions undertaken by the Federal Deposit Insurance Corporation are resolutions of small banks with solely US assets. In the UK context, the ease of resolution of a major systemically important retail bank will be a function not only of the liability side of its balance sheet but also of the asset side. The deposit relationships could be rapidly moved to a private sector purchaser or a bridge bank under the Banking Act 2009, but the ability of the authorities to transfer assets to match those deposits will depend on the location and nature of the assets created by the retail bank. If those assets are UK or EEA loan assets, this task may be relatively easy;²⁵ but if the assets are located elsewhere it is not clear that their transfer under the Banking Act 2009 will be recognised.
- Secondly, assuming that the ring-fencing requirement leads to a higher incidence of banking group failure for the reasons given above but that the retail entity can be successfully resolved, whether the deadweight costs and disruption to the UK economy resulting from the failure of the non-retail part of the bank are worth incurring to achieve this structure. Although not a retail bank, we would expect that Lehman's failure (and the contagion resulting from it) had a significant impact on the UK economy. There is still no fully workable regime for investment bank failure in the UK and many of the factors which contributed to the costs of the failure of Lehman remain unaddressed.
- Third, whether customers unprotected by a deposit guarantee scheme (most businesses and protected businesses which owe their banks money) will be exposed to greater risk of knock on failure, because of the higher risk of failure of the retail bank.

Question 4.5: 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)?

The risks of the retail banking ring-fence

108. The primary motivation behind implementing a retail banking ring-fence appears to be reducing the social cost of future financial crises (in terms of

²⁵ Reorganisation measures will be recognised elsewhere in the EEA by virtue of the Winding-up Directive.

bailout costs). In essence, the argument which appears to be advanced is that ring-fence will enable authorities to let wholesale and investment banking activities fail. Based on the experiences of the current financial crisis, large pure wholesale/investment banks cannot fail without injurious consequences for whole banking system including retail banks: the Lehman failure and the hastily arranged takeover of other US investment banks by stronger banks with retail businesses both demonstrate this fact.

109. Due to the inextricable link between retail banking and wholesale banking (as a source of finance), it is not safe to assume that the ring-fence will "insulate" retail banks from financial crises that affect wholesale banks. Therefore in certain circumstances, the failure of wholesale banks can make debt refinancing difficult for retail banks. This could adversely affect retail banks' ability to continue their day-to-day operations during a financial crisis, for example lending to households and businesses (a key aim of the Commission's reform proposals)²⁶. Therefore, the ring-fence could lead to a substantial increase in the cost of capital, while doing little to reduce the costs and likelihood of financial crises. The failure of businesses such as Northern Rock, which was precipitated by a lack of wholesale funding indicate that this risk is present in pure retail banks whether or not connected structurally with a wholesale bank. Apart from Lehmans and RBS, the failures in the UK in the recent crisis appear to have been in substantially retail businesses²⁷, while a number of universal banks did better.
110. Financial crises occur at erratic intervals and tend to be different in their origin and impact. We urge that the Commission consider carefully the CBA for this proposal and also consider whether a UK-only measure of this sort, addressing perceptions about the last crisis, is warranted by the actual UK experience, where the most seriously affected UK banks, apart from RBS, were either entirely in, or oriented towards, the retail and UK corporate lending sectors.

The costs of the retail banking ring-fence

111. The cost-benefit methodology outlined in Annex 3 does not appear to seek to quantify the costs to the UK economy of an increased incidence of investment bank failure, as explained in our response to Question 4.4. The methodology should also consider the costs of allowing the non-ringfenced businesses of universal banks and pure investment/wholesale banks to fail in the event of financial crises. Failure of non-retail portions of banking sector would have substantial costs for the economy.
112. The Commission also identifies a number of adverse consequences of the ring-fence for international competitiveness²⁸, namely a reduction in corporation and employment taxes, and a reduction in additional services (for example, consultancy services) purchased by banks²⁹. These costs should be considered in the CBA.

²⁶ Commission Interim report, Paragraph 2.95

²⁷ The characterisation of loans to larger corporates as "wholesale" appears somewhat arbitrary: essentially they require the same banking services (e.g. money receipt and transmission, overdraft and balance netting arrangements and term loans) in the same way as smaller businesses, although larger companies are more likely for their own account to take part in additional activities, such as derivatives trading.

²⁸ Commission Interim report, Paragraphs 4.160

²⁹ Commission Interim report, Paragraphs 4.164-4.165

113. We also note that the cost-benefit methodology in Annex 3 assumes that "the passthrough from increased costs for some producers (UK universal banks) would therefore be limited by the presence of other, unaffected providers (non-banks and foreign banks) ...". To the extent that this implies an increase in the proportion of UK lending that is not provided by UK-headquartered banking groups, we explain in our response to Question 2.1 why we believe that it is likely to bring with it additional costs in the event of a future financial crisis, as the non-UK lenders withdraw to home markets, increasing the impact of the financial crisis for the UK economy.
114. The costs and the benefits of the retail banking ring-fence is highly dependent on the detail, namely how the ring-fence will work in practice. This includes the design of the ring-fence (what services will be included in the retail ring-fence, and how capital will be divided). The CBA should also consider the implementation of the ring-fence, particularly the capital transfer rules. Under the Commission's proposals, universal banks are free to transfer capital from UK retail banking activities, to their other operations, providing the retail divisions capital levels are maintained above the proposed threshold. The ability of banks to utilise this source of capital is dependent on the flexibility of the capital transfer rules. If these rules are not sufficiently flexible, the rules could impose a barrier to the effectiveness of intra-bank capital flows, leading to an inefficient aggregate level of capital across the bank (i.e. higher than needed to meet risks and regulatory requirements).

Question 4.6: How should a UK retail ring-fence be designed (noting Annex 7)?

115. We are concerned at the implications of a narrowly drawn ring fence for a number of reasons.
116. Leaving aside the question of whether restrictions on the geographic scope of the activities of the retail entity (as discussed in paragraphs 12 to 14 of Annex 7) would be consistent with European single market rules, such restrictions would appear to make global banking more costly for UK banking groups. This may lead to a migration of activity over time to non-UK banking groups. We discuss the undesirability of such a migration in our answer to Question 2.1.
117. Restrictions on the ability of the retail entity to make loans to large corporate customers and lend in the interbank market would be likely to lead to a decrease in the availability of credit to corporate borrowers and an increase in their cost of credit. Further work is required to assess the negative economic impact of such a decrease in credit availability. In particular if this disrupted group balance netting as currently practised, the cost and risk profile for these businesses would be adversely affected and they would be forced to accept less economically efficient arrangements.
118. Generally, restrictions on the geographic areas or business segments in which the retail entity may operate will tend to reduce the diversification of the UK retail entity and thereby increase its risk of failure; and, by compelling all UK retail entities to adopt more similar business models, will also tend to ensure that failures of UK retail entities are more highly synchronised than at present.

119. We also note that to the extent that the retail entity did not own all systems and infrastructure necessary to conduct its operations, the existing provisions under the Banking Act 2009 relating to transfers of assets and the duties of a bank administrator or bank liquidator would need to be reviewed to ensure that the retail entity would be assured of continued access to these systems and infrastructure after a failure.
120. If separation within banking groups is to be recommended, we would favour separation and separate funding of the payment operations services of the bank, so that it could continue to operate in the event of resolution to support the operation of bank accounts in any part of the group and for a bridge bank during a period of reorganisation. This would reduce the need for recapitalisation of a failing bank, and improve the management of guaranteed deposit transactions, but with much lower costs of business separation.

Question 4.7: Should the Commission pursue any other structural reforms to promote stability?

121. We are not aware of any other structural reforms which the Commission should pursue, save for operational separation only, as suggested in the final paragraph of the previous answer.

Question 4.8: Do you agree with the Commission's assessment of the impact on the competitiveness of the City and the UK economy of the reforms it is considering? Can you provide further data and analysis in this area?

122. We think that it is too early to be clear what the impact will be. In particular, the impact will depend on the exact scope and severity of the retail ring-fence (as to which, see our observations in response to questions 4.4 to 4.6 and on cost benefit analysis in Annex 1 to this paper). The impact will also vary between different institutions, and, in terms of the wider economy, cannot be looked at in isolation, but must be assessed in the round with other reforms and laws/regulations (e.g. regarding resolution and prudential regulation).
123. The impact will also depend on the type of reforms that are adopted in other jurisdictions. For instance, we think that it is important to bear in mind in this context that, in the United States, insured deposit-taking banks have long been subject to ring-fencing in several important respects (e.g. they are prohibited from engaging in investment banking activities (any securities business must broadly speaking be conducted through separately capitalised affiliates) and they are also limited in their ability to provide any funding to their affiliates). Moreover, in the context of capital requirements, Switzerland has announced levels for Credit Suisse and UBS that are materially higher than those recommended by the Commission (i.e. 19% for all operations to be made up of 10% common equity and 9% convertible notes). By contrast, other jurisdictions including major jurisdictions in the EU impose less stringent requirements. We think that the impact on the competitiveness of UK institutions cannot be assessed until the global picture becomes much clearer.
124. In the circumstances we think it important that the Commission highlights to Government the inherent uncertainty in assessing impact at this stage in the

reaction to the banking crisis and urges Government to carry out repeated assessments and CBAs in relation to each measure it decides to implement, particularly where it moves beyond EU requirements. Major EU jurisdiction seems likely to maintain universal banks and these will be the closest competitors for UK based financial institutions, as well as offering alternative regulatory centres for banks currently regulated in the UK.

Question 4.9: Do you agree with the Commission's intention to consider a package of measures, and do you think that some elements could be relaxed if others were strengthened?

125. Where more than one measure is proposed care must be taken that the measures work together to provide protection (e.g. the increased capital requirements are appropriate in the context of a ring-fenced commercial bank and vice-versa and that there is not "overkill"). The Commission has also a responsibility to take into account the other regulatory measures under consideration in the UK and Europe and the rules being introduced on resolution. Several of these measures are still in a state of evolution and the Commission should address the risk that "UK only" elements of the overall package could turn out to be very damaging if that context is not kept under constant review.
126. It is very important that the overall package, including initiatives of EU and international level, is measured and balanced, in order that the impact on the affected institutions is not disproportionate and the impact on the wider economy is limited. It is also important that the measures focus on the relevant issues (e.g. protecting retail deposits, rather than necessarily trying to curb investment banking per se). This all requires a package that includes several different measures, but without excessive or draconian measures in any particular area. UK only measures will need to be adapted to work with the EU framework as it evolves, so as to ensure compatibility and avoid unintended adverse effects from combinations of different measures. It is not just banks, but the entire economy and the standard of living of individuals which will suffer if the measures have adverse effects.

Question 4.10: Over what timeframe should any reforms be implemented?

127. We cannot really comment on this at this stage – timing will depend on the ultimate severity of the total reform package (including EU prudential and regulatory requirements and the form of retail ring-fence). A balance will need to be struck between, on the one hand, allowing institutions sufficient time to make the required changes (taking into account the significant administrative efforts and costs involved), and, on the other hand, enforcing the changes in a timely manner to ensure their impact is maximised.

REFORM OPTIONS – COMPETITION

Question 5.1: Do you agree with the three broad measures proposed in this chapter (structural change, improvements to switching and barriers to entry, and pro-competitive financial regulation)?

128. In general the Law Society believes that competitive markets are important for delivering good value for customers. Nowhere is this more important than in the area of retail financial services. The following arguments are made from the perspective that bank customers are best served by the freedom to choose the products and services most appropriate to their situation and which are delivered by responsive and innovative banks offering good value products and services.

Structural reforms to promote competition

129. The Commission's proposal is that the divestment required of LBG should be enhanced substantially, or there should be a market investigation reference (albeit it observes that this may be lengthy process, particularly if decisions are appealed)³⁰. This has the stated objective of reducing market concentration and strengthening the divestiture's ability to act as a challenger.

130. Accordingly, the premise that is being advanced is that there is a structural competition problem of there being too few competitors, with LBG being described by the IBC as a "*clear leader across a number of key retail banking markets even after the divestitures*".³¹

131. However, it would seem to be a questionable premise that there is a structural competition problem given that the structure of the various UK retail banking markets are unconcentrated to moderately concentrated according to universal antitrust standards:

- For example, the US Department of Justice's and Federal Trade Commission's Horizontal merger guidelines of August 2010 state that:

"the Agencies generally classify markets into three types:

- Unconcentrated Markets: HHI below 1500*
- Moderately Concentrated Markets: HHI between 1500 and 2500*
- Highly Concentrated Markets: HHI above 2500."*

On this basis, the majority of the markets identified are unconcentrated, with the Personal Current Accounts (PCA) market with an HHI of 1570 (post-divestment) being borderline between unconcentrated and moderately concentrated and the SME banking market being moderately concentrated.

- The UK authorities draw the lines differently and define highly concentrated markets as markets with an HHI in excess of 2000. According to the Merger Guidelines, a merger leading to an increase in HHI of less than 250 in

³⁰ Paragraphs 5.13 and 5.14 of the Interim Report.

³¹ Paragraph 5.7 of the Interim Report.

markets which are not highly concentrated are “not likely to give rise to concern”.

132. None of the UK retail banking markets has a national HHI of 2000 or more (the highest being SME banking with 1720). The increment in HHI caused by the financial crisis has (with one exception) been below the threshold of 250, which means that (in a merger control context) the presumption of absence of concerns for the increase in concentration applies. Even in PCAs, the increment in concentration, post-divestment, (increment in HHI of 280) has barely been above the 250 threshold.
133. This does not mean that a moderately concentrated market structure could never lead to competition concerns. It merely means that evidence is required to overcome the general presumption of absence of concern. The Interim Report does not contain such evidence.
134. The Commission’s reference to LBG being the “*clear leader*” across a number of banking markets must be judged in the context that its market share post divestment ranges from 18-25% depending on the market considered. This level of market share raises the same issues as the analysis of market concentration. LBG’s market share does not provide any basis for concluding that LBG enjoys a single firm dominant position in any of these markets, particularly given the strength and scale of its UK rivals. Both the European Commission Staff Paper and the EUMR make clear that “undertakings with market shares of no more than 25 % are not likely to enjoy a (single) dominant position on the market concerned.” Again, this presumption can be overcome, but the Commission so far has not provided any evidence to do so.
135. The second justification for a structural intervention, i.e. that the LBG Divestment Business is “below the scale required to mount an effective competitive challenge” is equally speculative. As the Interim Report acknowledges, “the divestiture might be combined with existing UK banking.” This would significantly enlarge the scale of the new challenger. However, even as a standalone business, the Divestment Business has a market share comparable to other banks described by the OFT and Competition Commission as successful challengers.³²
136. Accordingly, it is far from clear that there is a structural competition issue. Against this background, no case has been made that forcing a larger scale divestment on LBG than that already agreed. It should also be borne in mind that competitiveness forms part of the EU Commission's state aid review which set the level of disposals.
137. In addition, a structural intervention would in all likelihood require primary legislation and would have to address issues of shareholder loss. Such structural intervention would also raise significant state aid issues in form of windfall gains to the purchaser of the LBG Divestment Business.
138. Forced transfer of individual and business accounts also raise issues for affected customers and we do not consider that the scale of forced transfer should be extended without highly compelling reasons.

³² For example in the Competition Commission’s 2001 report on the proposed Lloyds/Abbey merger, Abbey (market share 5%) and Halifax (pre-HBOS market share 5%) were described as effective challengers.

Improvements to switching and reductions of barriers to entry

139. The Commission is on firmer ground with its proposals about improvements to switching and reductions of barriers to entry. According to the EU Commission's Sector Inquiry Report on Retail Banking and its working papers, the UK has consumer current account switching around the EU average and the highest switching in Europe for SMEs at over 13%. As the business banking sector in the UK is more concentrated than that for consumers, this suggests that there may be factors which discourage individual switching. Yet the UK does not have a significant incidence of product tying or exit fees which clearly would deter switching in some EU countries and may UK Banks offer switching incentives to attract customers..
140. While as the Commission notes only a minority of those switching experience any difficulties and the OFT has taken steps to improve the process³³, there may well be further improvements in relation to switching of UK retail bank customers.
141. Particularly where switching can be improved with relatively little costs (e.g. improved information for customers), further measures may be appropriate. By contrast, where measures to improve switching is likely to lead to significant costs for the industry (and hence ultimately for customers), as, for example, in the case of number portability, a more detailed CBA is required. In this context, it is worth exploring whether improved switching can be achieved with lower cost options.
142. We think it is important that any recommendations to effect changes to improve switching should take fully into account the impact of the FSA's recently introduced regulatory requirements relating to moving a retail banking service set out in BCOBS 5.1.5 R.
143. The Commission has identified a number of barriers to entry, for example, access to a branch network for small banks wishing to compete as regards SME banking customers which need to withdraw large amounts of cash and cheques every day. However, with changes in payment methods in progress, including direct payments organised by phone or internet, use of credit and debit cards and electronic purses, automated methods of withdrawing and depositing cash which do not require bank premises, and the decline in use of cheques (whether or not they are ultimately withdrawn), it is far from clear that branch banking on the high street will remain as important as it has been or demand for cash as high.
144. We wonder if the recent coming into force of the Electronic Money Regulations 2011 (implementing the amended Electronic Money Directive) will provide a potential gateway for new market entrants, at least as regards some of the services traditionally provided by retail banks. E-money issuers are able to provide payment services (in addition to issuing e-money) on a reasonably mitigated regulatory basis. Becoming regulated as an e-money issuer may be an attractive entry point for a range of non-traditional market participants.

³³ Paragraph 5.15 of the Interim Report.

Promotion of competition by the FCA

145. We would agree with the statement by the Commission that “regulatory authorities should take care not to impede competition themselves.”
146. We favour the FCA having a duty to promote competition. This is in line with HM Treasury's proposals that the FCA will have an important competition role, including promoting switching and increasing transparency.³⁴ The details of the design of its responsibility and that of the OFT (or the proposed Competition and Markets Authority (CMA)) and a clear allocation of responsibilities are important and should aim to play to the strengths of each body and to provide for harmonious co-operation. We note the powers proposed by the Treasury Consultation on Financial Regulation, which members of this working group believe strike the right balance.³⁵

Question 5.2: Should the Commission pursue any other measures to promote competition?

147. We agree with the Commission that other structural measures (such as reversing the Lloyds TSB/HBOS merger or enhancing the RBS divestiture) would not be appropriate.
148. One obvious open question, namely whether there is merit in altering the pricing structure of the UK retail banking system, i.e. moving away from the system of “free banking” has not been addressed by the Commission and been suggested as a task for the future FCA. Work of this sort will need to be balanced with the fact that the “free banking” model has widespread acceptance and is regarded by consumers as useful to them. One of the largest areas of complaint about current accounts relates to unexpected charges, principally for taking overdrafts without prior agreement of terms.
149. Our view is that consumers should have choice to take account terms which they prefer and understand and that it would be wrong to mandate only one charging scheme. We also consider that a sensible regime for those going unexpectedly into overdraft would be of value to consumers, including some of the more vulnerable members of society, although this issue is only marginally related to competition issues.
150. We believe that a financial services regulator with a good understanding of related issues, such consumer credit law and practice and the operation of retail banking systems and payment systems is best placed to pull together all the threads and both improve transparency and consumer understanding of the cost of bank accounts and promote competition expressed in terms that consumers can understand. Market forces also encourage comparison. We note that terms comparison services are already available to consumers through web-sites such as Money.co.uk. Moneysupermarket.com, Lovemoney.com and Which4U.co.uk offer “top 10” selections and other bases of comparison for current and savings account and a wider range of services address comparisons on savings and mortgage products.

³⁴ A new approach to financial regulation: the blueprint for reform (ref footnote 20), page 34, para 2.111.

³⁵ The Law Society and Bar Joint Working Party on Competition Law have not commented on this proposal

151. In addition, the Law Society would expect new regulators, such as the FCA, to enforce rules effectively and fairly. To that end we welcome for example the proposed improvements in enforcement tools, for the benefit of consumers, proposed by the Treasury in their recent White Paper³⁶. Enforcement is a key element in ensuring a well functioning market, for example, by driving out poor practice and providing redress to consumers.

Question 5.3: What factors make smaller banks more likely to exert competitive pressure on larger incumbents?

152. We consider the most successful "smaller banks" are likely to be within or associated with otherwise successful large institutions which have brand recognition, e.g. supermarkets and other large retailers, insurers or well known overseas banks and/or to have novel business profiles – e.g. Egg was started by Prudential at the outset of internet banking and successfully exploited the new method of providing services. It is now owned by Citigroup and its credit card business is supplied by Barclays.
153. We note that if discussions in Basel result in tiered capital, smaller banks may have less onerous requirements, but will suffer being considered more risky. However, in competing for consumer customers whose credit balances are within the limits of the deposit guarantee scheme this should on balance be advantageous for smaller banks.

Question 5.4: Where are the limitations on customers' abilities to understand banking costs, compare different accounts, and switch between them?

154. As the Commission acknowledges, certain voluntary transparency initiatives relating to PCA costs and charges are presently being implemented following the OFT's work in retail banking and it is too early to see what the results of these changes will be³⁷. It would seem prudent to review the impact of the changes and recommend that any further work takes into account the impact of these.
155. More generally, in the absence of an appropriate benchmark we query the basis upon which conclusions are drawn about the current levels of switching and the effect upon competition in the PCA sector. In particular, the Commission does not appear to take into account the competitive constraint provided by (i) the potential to switch (despite acknowledging that only a minority of PCA customers who switch experience technical difficulties with the process); and (ii) multi-banking (where customers hold more than one current account product (as well as more than one savings product with different providers) concurrently). As regards the latter, the OFT's PCA market study noted that more than one third of UK customers have two or more current accounts.

³⁶See footnote 20.

³⁷ Paragraphs 3.36 and 5.18 of the Interim Report

Question 5.5: What costs might an improved switching process impose on banks and direct debit originators?

156. We assume that the Commission's reference to an "improved switching process" is intended primarily to refer to the introduction of a redirection system or possibly account number portability rather than more limited transparency obligations. It is right that the Commission should make further detailed enquiry into the likely costs of developing and implementing such measures since we expect that they would be very material (see the Competition Commission Report on Northern Ireland Current Account Banking at para 6.213-215, which concluded that number portability could only be introduced by a redesign of the entire UK clearing and payment system). Any such move would also have to be considered against the costs of providing security for payments in the system, protection of customer's personal data and the need to enable customers to maintain multiple bank accounts with different institutions. A thorough CBA (including appropriate consideration of who should bear such costs) is essential to ensure that any such proposal is proportionate.

Question 5.6: How could the costs of meeting prudential requirements be mitigated for small banks and new entrants, while ensuring safe practices in all banks?

157. This is primarily a technical systems issue which falls outside our expertise. We note that the EU is working on universal personal data protection rules which may in any event impose additional costs on banks and businesses of all sizes.³⁸ We do not think that potential customers of smaller banks would be attracted by an inherently more risky environment being permitted for such banks.
158. As mentioned above, regulation as an e-money issuer may present an opportunity for new participants to compete in relation to a number of services supplied by banks.

Question 5.7: How could small banks' ability to offer a national network of cash handling services be improved?

159. We agree with the principle that the prudential requirements for small banks and new entrants needs to be carefully balanced to ensure that there is adequate protection (given the lack of scale and/or track record) without placing such entities at a severe competitive disadvantage to larger operators or incumbents. However, we are not well placed to comment in detail on proposals to mitigate such costs through the use of shared capabilities or systems.
160. Although we are not best placed to provide a detailed response to this question we expect that there is scope for smaller banks to achieve national coverage of cash handling services through collaboration with larger competitors and third party service providers, including institutions such as the Post Office and large retailers, or by opening their own outlets.

³⁸ EU Commission Consultation and European Banking Federation Response of 13th January 2011.

Question 5.8: How should the Financial Conduct Authority discharge its duty to promote competition?

161. We agree that the FCA should have regard to competition considerations in devising and applying its rules, but its approach will need also to reflect and balance other regulatory objectives, with a view to sustainable competition between financially sound institutions. The Northern Rock history is an example of unchecked competition for market share using an imprudent and unsustainable business model; this was successful in raising market share very substantially and triggering responses from Halifax and other competitors, but led to business collapse and a sharp reduction in the range of competitive products offered. This lesson cannot be ignored.
162. It is our view that the competition powers of the FCA , whatever their extent should be exercised in close liaison with the OFT (or the proposed CMA).
163. The FCA should be well placed to bring together its technical expertise and its powers to obtain good outcomes for competition and consumers in relation to issues such as the switching process..

ANNEX 1

Section 1: Cost Benefit Analysis: Methodological issues

This section of the Annex addresses methodological issues in response to consultation question 2.2: "Do you agree with the analytical framework?"

The importance of robust and comprehensive cost and benefit analysis

We strongly support the Commission's decision to conduct Cost and Benefit Analysis (CBA) of the proposed reform options³⁹. CBA may provide a comprehensive and transparent framework to identify and appraise the consequences of different policy options, and CBA of all the feasible reform options could play a significant role in ensuring that an optimal overall package of reforms and policy initiatives is adopted.

The Commission is right to identify that there are a number of difficulties and complexities in carrying out CBA⁴⁰. However, this is precisely the circumstances where CBA is particularly important, with all of these issues being points which should guide the CBA carried out (see further below). A key feature of CBA is proportionality, namely that (i) regulatory measures should be proportionate to the detriments they are seeking to address and that (ii) the least onerous or costly measures are adopted amongst the range of alternative effective policy options.

The points made above about proportionality are worthy of elaboration. Proportionality to the detriments means that CBA cannot be limited to observing that financial crises are highly costly. This is because the relevant policy options do not include measures which reduce the probability of a financial crisis to zero or reduce the costs of such a crisis to zero, even if this were hypothetically to be possible. (We do not read the Commission's Interim Report as suggesting this, notwithstanding its illustrative calculations in paragraph 3 of Annex 3 which consider the benefits of reducing the probability of default to zero.) Any regulatory intervention aimed at reducing the probability or severity of a future crisis are likely to be subject to diminishing returns, namely that generally as the severity of measures increases the incremental benefits will fall and incremental costs will increase.

Similarly, it is equally important to consider the lowest cost way of achieving a particular objective. For example, measures to reduce the risk associated with non-retail bank activities, such as regulatory changes which reduce the risks of CDS trading and a range of other measures which reduce risk taking, may reduce the probability of failure; and these might be more cost effective alternatives than increasing capital requirements or at least matters which are relevant to have regard to in assessing the additional/incremental benefits for increasing capital requirements. (We are not seeking to arrive at a policy conclusion in making this point, but merely to indicate the range of options which need to be appraised.)

Reforms should be targeted to the precise problems, with this also providing clarity as to the benefits of reform options

It is appreciated that the causes of the financial crisis, and the reasons for the failures and difficulties of major financial institutions are complex, numerous, and not mutually exclusive. There are diverse viewpoints of the fundamental reasons, with there being significant controversy. These include, inter alia (and in no particular

³⁹ As indicated in paragraph 2.94 of the Interim Report.

⁴⁰ As indicated in paragraph 2.94 of the Interim Report.

order): imprudent mortgage lending; high exposure and reliance on short-term debt funding; excessive leverage; exposure to non-traditional financial products; a lack of incentives to avoid risky strategies; and a failure to appreciate and manage risks (including over reliance on rating agencies)⁴¹.

However, a natural starting point for the analysis is to consider the causes of the failures/difficulties of specific institutions, with this also providing clarity as to the benefits of various reform options. Banks experiences financial difficulties for a range of reasons during the financial crises. For example, certain large banks needed substantial government support as their capital cushions were not sufficiently large to absorb losses, with the scale of their exposure to risky investments and business activities potentially not being adequately captured through their risk and capital management strategies. On the other hand, a number of smaller banks/ex-building societies mortgage problems were due to their focus on the buy-to-let property market, and over-reliance on short-term wholesale money markets with this strategy becoming unsustainable when funding credit availability fell sharply during the credit crunch.

Identifying the reasons for bank problems will help identify the problems that exists in the current regulatory system and also why some banks were either able to avoid or manage the causes of failure without government support, while others needed huge bail outs or faced failure. This could then be used to identify the specific target or issue that each reform seeks to address, and thus the benefits of the reforms. We are not suggesting that the Commission seeks to identify the precise weaknesses or strengths of various financial institutions, but that this should be considered on a stylised basis as to precisely the matter that a particular policy option is intended to address and the associated benefits. This should also have regard to other policy initiatives which are being implemented or proposed.

This is an important step in CBA; it helps ensure that the "prescribed" intervention is the right tool to solve the problems that exist and also where supplementary measures may be required (or are already being implemented or contemplated) for an effective package of measures. Identifying the target of proposed reforms also helps identify the relevant costs and benefits of reform options.

It may also be useful to understand why certain institutions either avoided or managed the aforementioned failures/difficulties without direct government support. For instance, it is striking that certain banks did not reported quarterly losses during the financial crises, and moreover achieved this notwithstanding the failures and difficulties of competing institutions. Their relative success was due to a range of reasons, including sound business strategy (low exposure to high-risk untested securitised products and short term debt, and not being heavily reliant on wholesale banking), as well as a strong focus on risk management, and closely controlled liquidity and capital requirements. Such institutions which that either avoided or managed the failures/difficulties can also provide some guidance as to measures which may be effective.

The identification of costs and benefits

We agree with the broad Aims and Principles set out by the Commission.⁴² The Principles section focuses on a mixture of matters, and there may be merit in there being clarity as to their links with the defined Aims, with there potentially being a

⁴¹ There is a discussion of some of these points in the Interim Report; for example, at paragraphs 2.17-2.22.

⁴² As set out at paragraphs 2.95-6 of the Interim Report.

number of separate themes which are relevant to CBA. One of the Principles relates to the promotion of effective competition, with this principle being considered separately⁴³.

Aims and benefits

The Commission has stated that its recommendations will have three aims, with the primary aim no doubt being the first aim of seeking to reduce the probability and adverse impact of future financial crises⁴⁴. The other two aims relating to the flow of credit, and the payment system, guaranteeing capital certainty and liquidity for small savers could reasonably be viewed as subsidiary elements of the first, primary aim. We agree with these aims.

Large amounts of government money were injected into the financial systems: tax payers provided substantial levels of support to Royal Bank of Scotland and Lloyds Banking Group and banks such as Northern Rock and Bradford & Bingley were nationalised. This had significant implications for UK public finances, and is a relevant risk factor associated with a financial crisis⁴⁵. However, this should not be over emphasised, because more importantly the crisis also contributed to a deep economic recession, characterised by low household purchasing power, high unemployment, and a shrinking economy, with low economic growth. This point also flows from the estimates cited in the Interim Report from a Basel Committee on Banking Supervision study that the adverse impact of a financial crisis amount to 19-163% of GDP in net present value terms⁴⁶. Accordingly, it can be reasonably argued that the most significant damage of the financial crisis was its effect on the national and global real economy. Therefore, reducing the burden of future financial crises on public finances may be viewed as a subsidiary objective, and one which can be addressed by measures aimed at increasing the robustness of the banking sector.

Mechanisms for implementing the Aims

The first two matters identified in the section on Principles relate to two specific mechanisms by which the Aims may be achieved, namely by curbing incentives for excessive risk taking and reducing the costs of systematic financial crises⁴⁷. Other mechanisms could also be identified (for example, other measures to reduce the probability of future financial crises).

The costs of intervention

The fourth and fifth principles relate to the various intervention costs, namely impact on GDP, fiscal implications (i.e. tax), UK competitiveness, and impact on non-banks. Whilst these are broad measures, there would be merit in a wide range of specific intervention impacts being assessed (such as the cost of credit, the availability of credit, links with savings rates, impact on bank profitability and so on).

The analysis should also capture any distributional effects by identify whether reforms disproportionately affect certain parties. For example, if the reforms were to lead to increased credit rationing, consumers or businesses that currently have limited access to banking services and for whom alternatives lines of credit are considerably less favourable will be worse hit. Sectors that are highly reliant on debt

⁴³ (2.96 C) of the Interim Report.

⁴⁴ Paragraph 2.95 of the Interim Report.

⁴⁵ As emphasised at paragraphs 2.23 to 2.25 of the Interim Report.

⁴⁶ Paragraph 3 of Annex 3 of the Interim Report.

⁴⁷ Paragraph 2.96 A) and B) of the Interim Report.

financing, as well as start-up businesses, often viewed by banks as high risk, may also find it harder to source finance. This could lead to a debt funding gap, which could adversely affect the development and viability of a business, and therefore, aggregate levels of economic activity.

CBA should also consider transitional provisions⁴⁸. For example, it is important to assess what happens during the transition period as banks build up the capital stocks to comply with the new regulatory requirements. Over this period customers may have difficulties accessing finance if banks reduce their levels of lending to ensure they meet regulatory requirements. Therefore, immediate implementation of increased liquidity requirements could have an adverse impact on new lending. The CBA should examine whether any transitional costs can be reduced by phasing measures in over time.

The Interim Report identifies that CBA is complicated by various considerations, including how the costs of higher levels of regulation will be distributed across banks' customers, investors and employees, and the balance between private and social costs/benefits more generally.⁴⁹ Any assessment of cost and benefits should consider these points, including both social and private costs/benefits (i.e. including bank profits).

The quantification of costs and benefits

We acknowledge the challenges and risks of evaluating the proposed reforms using a purely quantitative CBA. In practice, while a number costs and benefits can be quantified, measuring all the relevant costs and benefits may not be possible. Nonetheless, without establishing magnitudes for the relevant benefits and costs, the overall effect of the proposed reform options will be difficult to gauge. Therefore, we support the Commission's method of conducting quantitative CBA to the extent possible, coupled with a core analytical framework to enable qualitative, as well as quantitative assessment. Whether qualitative or quantitative, the Commission should adhere to the fundamentals of CBA. For each reform option, the analysis should determine the preferred solution by: identifying and describing all the costs and benefits; assessing the likely or approximate magnitude/importance of each cost and benefit (whether quantitative or qualitative); and, analysing the relationships and trade-offs between the costs and benefits to identify the preferred option.

The analysis should have regard to both the quantum of costs and benefits, and their chances of being realised. The reform options will produce a stream of costs and benefits, which will be realised in different time periods. Therefore, the CBA should also take into account the timing at which costs and benefits occur, using standard discounting techniques. This will permit comparison of costs and benefits that occur over a number of years. This is particularly important when analysing the impact of financial stability reform options. Based on historical evidence, financial crises are relatively uncommon. The BCBS estimate that a major financial crisis occurs every 20 years or so⁵⁰ may be viewed as somewhat pessimistic. Therefore, the benefits of these reforms in terms of mitigating the effects of the next financial crises will not be realised till well into the future. Whereas, banks, their stakeholders and the UK economy, will begin incurring costs as soon as measures are implemented.

⁴⁸ The third bullet point of paragraph 2.93 of the Interim Report refers to "the importance of considering the transitional impact of any reforms".

⁴⁹ See the fourth and fifth bullet points of paragraph 2.93 of the Interim Report.

⁵⁰ See paragraph 3 of Annex 3.

Annex 3 reports the results of some recent studies which focus on the impact of higher equity capital requirements on the cost of credit and the annual GDP loss. As regards costs, this would seem to be a matter which warrants further research, particularly where reforms may have direct and indirect adverse consequences on matters such as the quantity of lending available for funding investment. Moreover, no other cost estimates are cited for any other intervention option, and the only other option discussed at all in Annex 3 relates to having a UK retail ring-fence.

Coordination with international regulatory developments is essential for optimal policy development

As the Commission is well aware, there is an array of national and international financial stability regulatory and policy developments underway that will influence the structure of the UK's regulatory environment. These are led by a number of international bodies, namely the European Commission, the Basel Committee on Banking Supervision, and the Financial Stability Board and its members. The optimal package of measures recommended by the Commission should be aligned with the aforementioned initiatives, with the Commission noting both the risk of potential regulatory arbitrage⁵¹ (which has ample scope to distort competition should different institutions face appreciably different regulatory regimes, with this depending not just on the rules specified but how they are applied in practice) and the importance of having regard to the effects of wide regulatory reforms⁵².

CBA in this context would consider each individual measure, or combination of measures, with the objective of identifying the incremental benefit and costs of such measures, compared to those that would have been incurred if no action was taken. This baseline of "doing nothing" in this case must have regard to the regulatory environment determined by the outcomes of the aforementioned international bodies' work. The baseline for assessing each of the individual measure, or combination of measures, needs to be explicit, and all costs and benefits should be judged against it. For example, the Basel III agreement has increased the international standard baseline ratio of equity to risk-weighted assets to 7%. The Commission propose an increase of this ratio to 10% for systemically important banks, and for large UK retail banks⁵³. Therefore, when assessing the impact of this reform proposal, the 7% equity to risk-weight assets ratio should form part of the baseline regulatory environment.

In certain circumstances, where "doing nothing" is not credible or the reform option under investigation has a scale aspect (e.g. the level to set the minimum loss absorbing capital requirements), the appropriate baseline may be "doing the minimum" (the least interventionist approach possible).

One complexity with the methodology advocated above is that the overall regulatory regime is in a state of flux: there are uncertainties about the structure of new regulatory environment (which will depend on the Commission's decisions, as well as reforms underway at the national, European and international level). Therefore, the baseline regulatory environment used to calculate the incremental benefits and costs is not readily available. However, without an appropriate comparator, it is difficult to identify the impact of reform proposals. This points towards having conditional CBA assessments and recommendations for policy changes, which vary according to the scope and implementation of other domestic and international regulatory measures.

⁵¹ The second bullet point of paragraph 2.93 of the Interim Report.

⁵² Paragraph 2.96 E) of the Interim Report.

⁵³ See, for example, the final paragraph of page 6 of the Interim Report.

The devil is in the detail – CBA should guide detailed recommendations

CBA must be proportionate to the potential impact and risks of implementing a proposal. Getting regulatory reform wrong could harm the financial sector, the economy, and the UK's competitiveness, while doing little to decrease the probability and mitigate the impact of financial crises. The CBA produced with the interim report examines two of the proposed reform options (increased loss absorbency through higher equity requirements, and the retail banking ring-fence). The Commission should expand this analysis to cover the full array of reasonable options, including possible competition reforms.

As regards competition reforms, these are of a very different nature to the other regulatory issues and are largely separate.

CBA should also guide the detail of the policy options advocated. For many of the reforms proposed, there are a number of alternative methods for implementation. The Commission report will be most effective if its recommendations are not too high level, but addresses scope and implementation as well. CBA can provide an analytical framework to compare and contrast this detail. For example, the Commission has invited views on the best design for the retail ring-fence in contemplating a ring-fence to isolate and safeguard retail banking, with the issue not merely being one of having such a ring-fence but its precise scope and implementation. Once the full range of feasible structures for its design is determined, the costs and benefits of each potential structure should be given full consideration. For example, this could consider the difference in costs and benefits when corporate banking is included and excluded from the ring-fence.

Section 2: The detail of the Commission's analysis as regards increasing bank equity

This section of this annex addresses the Commission's application of CBA.

The main matter to which CBA has been applied relates to increasing bank equity. The Commission refers to two studies and arrives at the view that the optimum equity ratio is at least 10% for all systematically important banks. However, a number of points can be made.

The two studies yield very different results as to optimum capital levels (See Figure A3.1). Taking the BIS estimates, this would point to an optimum equity ratio of about 7-10%. To justify a figure at the top end of this range, the Commission advances four arguments:

- First, the lower figure of 7% assumes that a crisis costs 19% of GDP in present value terms, which the Commission describes as "extremely conservative" and that a future crisis could be 5 or more times larger. However, these calculations take no account of an array of other measures which will be implemented which will reduce the probability and severity of failures - the benefits of increasing equity further should take these into account. In addition, CBA should consider the efficacy and cost of alternative measures to reduce the probability or seriousness of bank failures;
- More generally, all studies of benefits must make assumptions as to the frequency and adverse consequences of financial crises, which begs three observations:

- Severe crises have historically been very rare in the UK (the last crisis being the 1973-1975 secondary banking crisis). It would seem premature to conclude that the likelihood of future crises would increase in the absence of further regulatory measures beyond those which are already in the process of being implemented.
 - The magnitude of the benefits depend in large part on whether the effects are permanent to some degree (i.e. that the reduction in GDP is permanent). Arguments can be advanced that this is the case, but note that this amounts to assuming that above average economic growth does not occur after a banking crisis (so as to return the economy to pre-crisis economic growth rates) and that the natural rate of unemployment has permanently increased.
 - Query whether recent GDP levels and growth were driven in part by the widespread availability of cheap credit which was attributable to prevailing regulatory regimes. The ending of this could have permanent effects, but the loss of such GDP benefits cannot be counted as a marginal benefit from further regulation.
- Second, the BCBS estimates do not take account of how reducing leverage should reduce the cost of equity, thereby reducing the increase in the cost of credit and thus the adverse effect on GDP. (It could also be argued that reducing leverage may reduce the cost of debt, depending, for example, on the extent that debt providers assume that banks will be bailed out.) Similarly, increasing equity will increase the tax costs to banks, but these are transfers from the banks to the government. These are legitimate observations, even if the effect on the cost of equity of lower leverage are far from simple to estimate. However, the methodology by which increases in credit costs are translated into output changes depends on a range of assumptions. For example, it is legitimate to query whether increasing equity will affect the quantum of overall lending (i.e. beyond credit price effects), with concerns currently being expressed as to the availability of credit, which potentially could have greater output effects. It is also assumed that the marginal reduction in GDP from reducing leverage are constant; i.e. that each 1% increase in the equity ratio has the same adverse incremental effect on output. However, it seems plausible that the adverse effects on output increase as credit costs increase (for example, it may be easier for firms to use alternative sources of credit to bank debt or more labour in response to a small increase in credit costs, but increasing substitution may become more costly and difficult as bank credit costs increase).
- A common theme across both the studies is that marginal benefits decline after 7%, with the declines being sharp across 3 of the 4 model scenarios. Accordingly, the incremental benefits of moving beyond 7% are relatively small. This does not mean that incremental benefits are not worth pursuing, but it does in particular mean that a focus on correctly measuring the incremental costs becomes more important.
- The third and fourth arguments seek to identify wider issues beyond GDP based models, observing (reasonably) that there may be wider benefits to reducing the risk and severity of a bank crisis because:
 - Consumers value income/employment stability. This is a reasonable observation, but they also value cheaper credit and such arguments need to be quantified. The optimal equity ratio for consumers could be lower (as well as higher) than that suggested by a GDP model.

- Government support for banks is costly. This is a reasonable observation, but such arguments need to be quantified. (For example, the stakes the government has in RBS and LBG may be sold for a profit).

ANNEX 2

Law Society Working Group: Membership

John Wotton (Vice President) - The Law Society

Dorothy Livingston (Chair) - Herbert Smith LLP

Patrick Buckingham - Herbert Smith LLP

Christian Ahlborn - Linklaters LLP

Mark Clough QC - Brodies LLP

Mat Hughes - Ashurst

Greg Olsen - Clifford Chance LLP

Penny Sanders - Wragge & Co

Deidre Trapp - Freshfields LLP

Phillip Wood - Allen & Overy LLP