



House of Commons  
Treasury Committee

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# **Independent Commission on Banking**

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**Nineteenth Report of Session 2010–12**





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*Report, together with formal minutes, oral and  
written evidence*

*Ordered by the House of Commons  
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## The Treasury Committee

The Treasury Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of HM Treasury, HM Revenue and Customs and associated public bodies.

### Current membership

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Tom Blenkinsop MP (*Labour, Middlesbrough South and East Cleveland*)  
John Cryer MP (*Labour, Leyton and Wanstead*)  
Michael Fallon MP (*Conservative, Sevenoaks*)  
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John Thurso MP (*Liberal Democrat, Caithness, Sutherland, and Easter Ross*)

Mr Chuka Umunna MP (*Labour, Streatham*) was also a member of the Committee during the inquiry.

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The Reports of the Committee, the formal minutes relating to that report, oral evidence taken and some or all written evidence are available in printed volume(s). Additional written evidence may be published on the internet only.

### Committee staff

The current staff of the Committee are Chris Stanton (Clerk), David Slater (Second Clerk), Jay Sheth, Peter Stam and Daniel Fairhead (Committee Specialists), Phil Jones (Senior Committee Assistant), Caroline McElwee (Committee Assistant), Steve Price (Committee Support Assistant) and Nick Davies (Media Officer).

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## Summary

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The Independent Commission on Banking (ICB) has been set up to examine the structure of UK banking and put forward reforms to the banking system to promote financial stability and competition.

The Treasury Committee has not attempted to reach a definitive view on the ICB's proposals, since the ICB report is itself an interim one. Instead, our inquiry has sought to focus on the key questions which we think the ICB will need to address in its final report as well as areas where we believe it is necessary for the ICB to secure some measure of agreement with the banks.

In its Interim Report, the ICB described the proposal for a retail ring-fence as its lead option at the present time and devoted a large proportion of its report to discussing this reform option. Our emphasis in this report has therefore been on the ICB's proposal for a retail ring-fence. This should not be taken as either an endorsement for or a rejection of a ring-fence.

Other reform options such as full structural separation, and a non-structural approach based around higher capital requirements alone, received far less attention from the Commission. The lack of detailed analysis of the benefits and costs of alternatives to a ring-fence was a disappointing feature of the Interim Report. Arguments for and against alternatives to a retail ring-fence have been put to us in evidence and should play a larger role in the debate about fundamental reforms to the banking system. It is crucial that the ICB does everything possible in its final report to remedy this omission.

More detailed analysis of the costs and benefits of the various proposals, as well as their impact on financial stability, long-term economic growth, business lending and the competitiveness of the UK banking sector, is required. A final judgement on the merits of the ring-fence versus full structural separation or solutions based on higher capital levels and loss-absorbing debt can then more readily be made.

# 1 Introduction

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1. The Independent Commission on Banking (the Vickers Commission) was established by the Government in June 2010 to “consider the structure of the UK banking sector, and look at structural and non-structural measures to reform the banking system and promote competition”. The ICB was charged with formulating policy recommendations with a view to:

- Reducing systemic risk in the banking sector, exploring the risk posed by banks of different size, scale and function;
- Mitigating moral hazard in the banking system;
- Reducing both the likelihood and impact of firm failure; and
- Promoting competition in both retail and investment banking with a view to ensuring that the needs of banks’ customers and clients are efficiently served, and in particular considering the extent to which large banks gain competitive advantage from being perceived as too big to fail.<sup>1</sup>

2. The Commission published its Interim Report on 11 April 2011. In summary, on financial stability, the Commission has proposed:

- measures which “makes banks better able to absorb losses”. This would be achieved through making banks hold more equity relative to their assets and the ICB has recommended that a “10% equity baseline” should “apply to large UK retail banking operations”. The Commission has also suggested that “contingent capital and debt capable of so-called ‘bail-in’ might be able to contribute to greater loss absorbency in the future”;
- “isolating the UK retail banking activities within a universal bank and placing them into a separately capitalised subsidiary which the ICB has termed a ‘retail ring-fence’”.

3. The ICB has contrasted its chosen approach with the alternatives—namely, structural radicalism, requiring retail and wholesale and investment banking to be in separate firms with restrictions on cross-ownership, or being *laissez-faire* about structure and seeking to achieve stability by very high capital requirements across the board. The ICB believes that its chosen approach—what it describes as “a complementary combination of more moderate measures towards loss-absorbency and structure”—is likely to be “the most effective approach”.

4. On competition, the ICB has floated a number of measures to help increase competition in the UK retail banking market. These include improving the personal current account switching process, introducing greater transparency, reducing barriers to entry, giving the new Financial Conduct Authority (FCA) a “clear primary duty to promote effective

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1 <http://bankingcommission.independent.gov.uk/bankingcommission/terms-of0reference/>

competition”, and most controversially requiring a “substantially enhanced divestment” by Lloyds Banking Group.<sup>2</sup>

5. The ICB will publish its final report in September 2011. The Commissioners have made it clear that they intend “to make a package of recommendations that stands as a package and not as a pick-and-choose”<sup>3</sup> Sir John Vickers and his Commissioner colleagues Bill Winters and Martin Taylor stressed that they are continuing to explore all other reform options and have not come to any firm decisions, especially in relation to the ring-fence.<sup>4</sup> At our evidence session they described the retail ring-fence as merely its “lead option” at the moment.<sup>5</sup> **The ICB has not yet come down in favour of either full separation, a retail ring-fence or, indeed, what it describes as a laissez-faire approach based on higher capital levels. Much greater detail is required on the work already done by the ICB on all these options. This should be made available at the time that the ICB is in a position to make a final set of recommendations. We are concerned that the option of full structural separation has not received sufficient analysis. To this end, we call on the ICB to provide further details as to the costs and benefits of this reform option and why it decided early against full separation when settling its lead option at the time of publication of the interim report.**

6. **Two areas which the ICB has not yet looked at are, first, the implications of its proposals for the conduct of corporate governance in banks, particularly given the passive shareholder response to the financial crisis, in spite of the significant damage to shareholder returns. Secondly, the regulatory arrangements for policing the ring-fence need careful explanation. We call on the ICB to do further work in both these areas ahead of the publication of their final report.**

7. The work of the ICB has taken place against a backdrop of rumours and suggestions that one or more of the large banks would move their head-quarters out of the UK if the Commission recommended full structural separation. The Commissioners confirmed that their recommendations were based on what they thought was “the right structure for the banking industry in UK” and not over whether their proposals would lead some banks to redomicile. However, one of the Commission’s members, Bill Winters did confirm that the Commissioners had:

spent some time thinking about whether either large universal banks or parts of universal banks were likely to re-domicile and concluded that, while possible, it is unlikely, based on the package of recommendations that we are making, but of course that is something that we continue to look at pretty carefully.<sup>6</sup>

8. The work of the ICB has taken place largely outside the public spotlight with the banks choosing to engage with the Commission in private rather than articulating their concerns

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2 ICB, *Interim Report, Consultation on Reform Options*, April 2011

3 Q 72–73

4 Q 1

5 *Ibid.*

6 Q 35

about aspects of the Vickers interim report in public. **The debate on the merits or otherwise of the ICB proposals must take place openly and transparently in the public eye. The banks must place their objections and concerns fully into the public domain. That said, we have recently seen encouraging signs that some of the large banks have become more willing to share their views with the Treasury Committee. The taxpayer deserves a full and public debate about the future direction and shape of our banking system. A final ICB report based on private discussion and agreement with the banks rather than rigorous public scrutiny would lack public credibility and acceptability.**

9. **The Committee has not attempted to reach a definitive view on the ICB's Interim proposals, since the ICB report is an interim one. We focus in this report on key questions which we think the ICB needs to address in its final report as well as issues on which we believe it is necessary for the ICB to secure some measure of agreement with the affected banks. Given that the ICB has proposed a retail ring-fence as its lead option our inquiry has focussed on this option. The Committee will examine carefully the ICB's final recommendations and may express a view at that time.**

10. Our inquiry was held over two evidence sessions. On 24 May we took evidence from 3 of the 5 ICB Commissioners: Sir John Vickers (chair), Martin Taylor and Bill Winters. On 8 June we took evidence from Douglas Flint, Group Chairman, HSBC, Stephen Hester, Chief Executive, RBS, Bob Diamond, Chief Executive, Barclays and António Horta-Osório, Chief Executive, Lloyds Banking Group.

11. We would like to thank Bill Allen, Professor Geoffrey Wood, Dr Pinar Bagci and Mark Falcon for their expert advice and assistance in this inquiry.<sup>7</sup>

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7 Relevant interests of specialist advisers are as follows (a complete listing of interests can be found in the Formal Minutes of the Committee available on the Committee's website):

- Professor Geoffrey Wood: Director, Hansa Trust; Member, Investment Advisory Panel, Strathclyde Pension fund; Member and Adviser, PI Capital (private equity group); Adviser, Elliot Advisors

- Bill Allen Financial and economic consultant; Two current consultancy contracts. One is with a company called Ad Satis Ltd (their internet site is <http://www.adsatis.com/>). Ad Satis itself provides consultancy services to banks, and the contract is to provide them with pieces of research on bank regulation. The other is with NBNK Investments PLC, which intends to acquire banking assets in the UK and establish a new retail banking company to compete with the established incumbents

- Pinar Bagci: Economic consultant advising companies on competition and regulatory matters. Clients have included regulators, competition authorities, companies, securities exchanges and investment and retail banks. I am currently not advising any banks on any matter but am working with Visa on the matter of interchange fees

- Mark Falcon: Nil

## 2 Government guarantee and implicit subsidy

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12. The banking crisis of August 2007 onwards revealed major structural flaws in banking systems around the world. In particular, it exposed the reality that governments felt unable to allow systemically important financial institutions to fail—the ‘too important to fail’ problem so that firms had an implicit government guarantee. This reluctance to allow such firms to fail reflects the high costs that would be associated with the failure of a systemically important bank which provides critical financial services to individuals and businesses, such as payments systems, and which is heavily connected to the rest of the financial system. The consequence however is, as we noted in our recent report on competition and choice in retail banking, that “firms which are perceived as ‘too important to fail’ are both protected from the discipline of the market place and derive tangible benefits from this status”.<sup>8</sup>

13. Annex 3 of the ICB’s Interim Report examined the size of the government guarantee of the banking system. It has looked at analysis by Andy Haldane at the Bank of England who estimated “that costs of funding were reduced by around £57bn per year on average over 2007–09 for the UK banks in aggregate” with the reduction in funding costs “proportionately larger for bigger banks, and bigger at end–2009 than in 2007–08”.<sup>9</sup> It has also studied a report from the economic consultants Oxera which examines the same issue from a different perspective and which valued the guarantee “at around £6bn per year on UK banks’ £7tn assets”.<sup>10</sup> The ICB itself concludes that the public guarantee reduces bank funding costs by “considerably in excess of £10bn per year”.<sup>11</sup>

14. We questioned the Commissioners on the size of the implicit subsidy to the banking sector. Sir John began by explaining that the subsidy was “a very hard thing to quantify”. He explained the size of the subsidy did not remain constant, but would vary over time. He cited Mr Haldane’s analysis that—at the height of the crisis—the subsidy was “in the region of £100 billion” per annum, adding that the size of the subsidy would fall “the further you are from the peak of the crisis”.<sup>12</sup> Sir John explained the difficulties of coming up with a precise figure over the economic cycle, stating that “the application of these methods to the pre-crisis period, when risk generally was massively under-appreciated and under-priced by these methods, would probably produce quite a low number, which would not be a sensible way of looking at the future from where we are now”.<sup>13</sup>

15. Despite being pressed, Sir John refused to come up with a more precise figure than ‘considerably in excess of £10bn’, explaining “it would raise false hopes to suggest that we

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8 Treasury Committee, Ninth Report of Session 2010–12, *Competition and choice in retail banking*, HC 612–I

9 ICB, *Interim Report, Consultation on Reform Options*, Annex 3, p 162–63, April 2011

10 The Oxera Report was commissioned by RBS

11 Q 2

12 *Ibid.*

13 Q 3

would come out with a precise consensual number, or even a narrow range that everyone can agree on”. Instead Sir John emphasised that “the key point” was “that in excess of £10 billion is a huge number, by any standard, and it is a measure of the scale of the problem, or one aspect of it, that we are dealt the task of addressing”.<sup>14</sup> He gave an example to hammer home his point:

if the figure were, say, £15 billion—and I don’t want to be precise about it because there is no sensible way to be very precise—that would be 1% of GDP, and if bank balance sheets, UK banks, are approximately four times GDP, that is a quarter of a percentage point, and I think that is an entirely realistic number. It could well be north of that.<sup>15</sup>

16. However, Sir John, when asked whether there was agreement between the major banks on the size of the subsidy, replied that there was as yet no agreement on the value of the subsidy. He went on to say that this was “one of many topics that were discussed” with the banks, but that “there were clearly very different views about the size of any subsidy”, adding that “some of the banks had many criticisms of the Haldane work”.<sup>16</sup> Bill Winters elaborated on this, explaining that the major banks all agreed that “in the pre-crisis period that the subsidy was very low” and that there was also “complete acknowledgement by the banks that the subsidy was very high during the crisis period”.<sup>17</sup> Sir John promised that he would try to achieve a consensus view with the major banks as to the size of the subsidy.<sup>18</sup>

17. We discussed which institutions benefited most from this subsidy. The Commissioners told us that “in broad terms the larger institutions benefit disproportionately more”, but again would not be drawn on the size of the subsidy for individual institutions.<sup>19</sup> Subsequently, the ICB sent us a supplementary memorandum, which whilst not breaking down the value of the subsidy to individual institutions, did attempt to gauge the relative size of the government guarantees of the four large banks—Barclays, HSBC, RBS and Lloyds Banking Group—by looking at two factors: the size of each banks assets, as a very rough measure of the amount of liabilities that are guaranteed; and the difference between each banks standalone and with-support credit rating as a rough indicator of how much each pound of funding is cheapened by the guarantee (see table one below). The ICB concluded that among the big four UK banks:

Barclays and HSBC have bigger balance sheets than RBS and Lloyds Banking Group, whereas the latter two banks enjoy larger ratings uplifts. It seems reasonable to conclude that each of the Big Four enjoys a considerable share of the total reduction in UK bank funding costs as a result of the implicit guarantee.<sup>20</sup>

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14 Q 3

15 Q 2

16 Q 17–22

17 Q 23

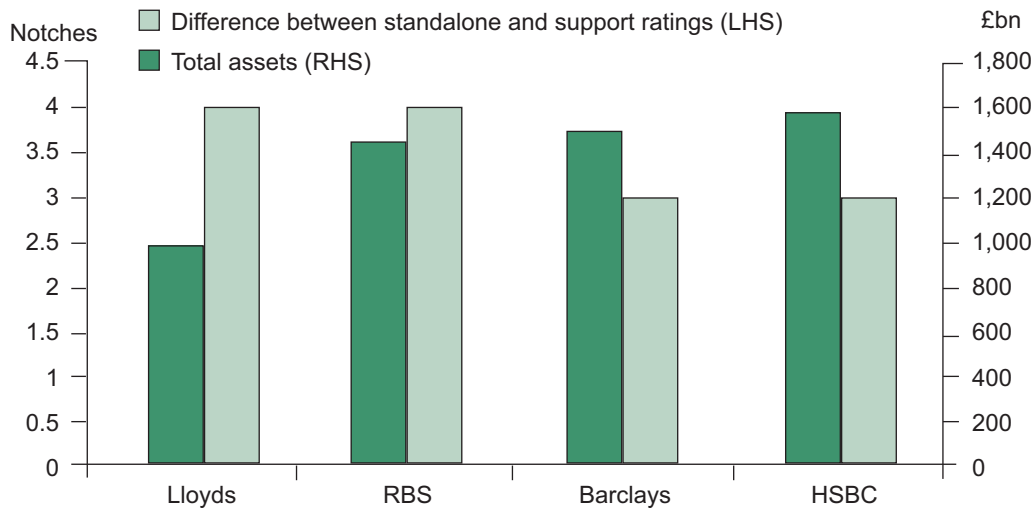
18 Q 22

19 Q 5–6

20 Ev 82

before cautioning that “one would risk spurious precision in going further than this”.<sup>21</sup>

**Table 1: The implicit subsidy provided to large UK banks by banking institution**



Source: 2010 published accounts, Moody's credit ratings, ICB calculations

18. We also sought information from the Commissioners as to the beneficiaries within individual institutions of this subsidy. Sir John Vickers believed it was “a mix”:

it is partly to those who own equity or debt in banks, it is partly to those who work in banks and it is linked to the question of remuneration, and some will go through to the customers of banks, but it is formidably difficult to get even a first estimate of how big the slices are that go in those different directions.<sup>22</sup>

19. We asked Sir John what would happen to the size of the implicit subsidy if his reforms were implemented. Sir John said total abolition was unlikely and that:

there are always going to be some circumstances in which governments would feel compelled to come to the rescue of some parts of banks. The aspiration of getting it to 0.0 I think is unrealistic. I think our measures, if Government and Parliament followed things of this kind, would have a major effect on reducing the size of the implicit subsidy, but I would also underline the importance of seeing UK measures in the wider international context.<sup>23</sup>

Bill Winters explained that the goal was a zero subsidy, but elaborated on the range of possible outcomes:

there is a very clear expectation from the banks—of course you will confirm this with them directly, as will we—that the expected subsidy prospectively is zero. Will we achieve zero? [...] it may be difficult to achieve zero. It is possible that the body of recommendations that we make and the actions that you take could overshoot, and the subsidy could become a cost to the banks. That is a possible outcome. Zero is a

21 Ev 82

22 Q 7

23 Q 9

possible outcome, and some residual subsidy is a possible outcome. I think there is a clear expectation from our committee, the Commission, and the banks that the target is zero, and that is what we are shooting for.<sup>24</sup>

20. We asked bank executives about the implicit subsidy—the size of the subsidy, the beneficiaries and whether they thought the subsidy could be eliminated. Bob Diamond, Barclays CEO, said he preferred to refer to it as an “implied Government guarantee” because the subsidy did not represent “a transfer of funds from taxpayers” to the banks.<sup>25</sup> Mr Diamond was reticent about the size of the subsidy, claiming it was “really hard to put a pin in this” and that it was “very different in varied markets. It is different in different environments. During the crisis it was quite large.” He argued the real issue was not around coming up with a concrete figure, but “working very hard together to make sure that there is no implied Government subsidy going forward”.<sup>26</sup>

21. Unlike Mr Diamond, Stephen Hester, Chief Executive at RBS, did not appear to have a problem with the use of the term ‘implicit subsidy’. However, like Mr Diamond he was reluctant to be drawn on a precise figure. Mr Hester went on to criticise the focus on the size of the subsidy, telling us that “I am not sure that I see the ability or even the benefit of agreeing what the number is. The point is, whatever the number is, let’s try and make it zero in the future and let’s examine the reforms that are going through to help achieve an outcome”.<sup>27</sup> When asked whether the implicit subsidy had fed through into bonuses and high levels of remuneration, Mr Hester replied that “to the extent that banks were able to carry less capital and fund cheaper in the past than would be true in the future, then one can say that that implicit subsidy, whatever its amount, could have fed through to lots of places”. These included he said “the price of loans to customers and, therefore, to the general economy. It could have fed through to the levels of employment in banks, in all bits of banks, and it could have fed through to bonuses, so I think one could assume that there might have been some leakage to all of the above”.<sup>28</sup>

**22. Much of our inquiry on the ICB Interim Report has focussed on the size of the implicit subsidy to the banking sector. The ICB, using the research of others, places the figure at considerably in excess of £10bn, but has not published detailed analysis as to how it arrived at this figure. The banks meanwhile have been reluctant or unable to come up with any credible figures. We have concluded there is an implicit subsidy. There is a need for at least some measure of agreement between the banks and the ICB about the minimum size of the implicit subsidy, now and in the past, as well as an agreed analytical framework for measuring the subsidy. The need for consensus in this area is critical because of the ICB’s goal, shared by the large banks, to eliminate this subsidy. Without an agreed framework for measuring the size of the subsidy it will be difficult to assess when success in this area has been achieved.**

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24 Q 23

25 Q 240

26 Q 271

27 Q 163

28 Q 169

23. Our inquiry has focussed on who the major beneficiaries—shareholders, employees, customers—within the banks of this implicit subsidy are, but has not succeeded in eliciting a clear answer. The ICB needs to do further analysis to identify the link between the implicit subsidy and high levels of remuneration for certain activities within banks. Otherwise the link between the implicit subsidy and high levels of remuneration in certain parts of the sector will remain a matter of enduring concern.

## 3 Structural reform options to promote financial stability

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### Structural reform options

24. The ICB has outlined a number of structural reform options to promote financial stability. One option which would have an impact on universal banks—banks that undertake a combination of retail, commercial, wholesale and investment banking activities—is structural separation. This could take a number of different forms, namely:

- full separation between retail and wholesale/investment banking, where the legal entities conducting these activities cannot be in the same corporate group;
- a retail ring-fence—the isolation of retail banking activities from non-retail banking activities by placing them in a separately capitalised subsidiary;
- operational subsidiarisation.<sup>29</sup>

The ICB has stressed it has not come to a final decision between these structural reform options, and has not “excluded the possibility of a total split”.<sup>30</sup> They have described the retail ring-fence as its “lead option” at the moment.<sup>31</sup> However, the ICB has devoted just a few pages of its interim report to discussing full separation and operational subsidiarisation. In particular, the ICB states that “the benefit of full separation is that it would guarantee separability in a crisis”. It argues that:

Should the need arise, the retail and wholesale/investment banks could be dealt with in isolation, using the appropriate resolution tools or insolvency procedures. This would be totally clear to creditors from the outset. A number of additional possible channels of contagion would be mitigated, such as the triggering of a crisis of confidence in a retail bank if a wholesale/investment bank of the same brand ran into difficulties. For the most part, full separation would increase the confidence that the problems described above would be successfully addressed.

Against this, the ICB cautions that “structural change should not impose restrictions which are more stringent than needed, so that banks can organise themselves in the most efficient way possible within the required constraints”. They go on to list some of the efficiencies which may be lost under full separation:

there may be economies of scope between retail and wholesale/investment banking which can be preserved within one financial group. For customers who require both retail and wholesale/investment banking services, there may be advantages in being able to source these from a single provider. Moreover, full separation would remove

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29 ICB, *Interim Report, Consultation on Reform Options*, chapter 4, April 2011

30 Q 81

31 Q 1

all intra-bank diversification benefits and so eliminate the possibility that one part of the group could save another part. Provided the activities are conducted in a way which is properly structured and capitalised, it may be possible to retain some of the benefits of mixing retail and wholesale/investment banking while still addressing the problems outlined above.

## Other financial stability initiatives taking place internationally

25. The ICB's work is taking place alongside a host of other initiatives at both international, European and UK level. It has stressed that its proposals—including the retail ring-fence—are designed to complement these other initiatives.

26. The Basel Committee on Banking Supervision (BCBS) has come up with proposals to strengthen capital and liquidity requirements.

27. Much activity is also taking place at international and UK level examining the framework for recovery and resolution of large complex financial institutions and at seeking to make institutions more resolvable in an orderly manner as they approach the point of failure. Such a facility, which has existed for some years in the USA, was proposed in the UK by the then Treasury Select Committee and the proposal was implemented in the Banking Act (2009).<sup>32</sup> The Act's centrepiece is a permanent special resolution regime, providing the authorities with a range of tools to deal with banks and building societies in financial difficulties. The procedure has already been successfully used to carry out the closure of the Dunfermline Building Society in 2009.

## Why a retail ring-fence?

28. The ICB has said it has focussed on universal banks because it has identified “three potential problems” to which it believes their “unrestricted combination within institutions” gives rise:

- high impact of failure;
- increased risk of system failure; and
- increased risk-taking.

The Commission has, in its interim report, concluded that “potential solutions to these problems are consistent with continuing to have universal banks in the UK, so long as they are appropriately structured and capitalised”.<sup>33</sup> They propose to do this by “isolating the UK retail banking activities within a universal bank and placing them into a separately capitalised subsidiary (called a ‘retail ring-fence’)”. In its Interim Report, the ICB explained that its ring-fence proposal “would require banks to maintain a minimum level of capital [10%] within their UK retail operations,” but that “any capital above this level could be

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32 The Banking Act 2009 creates a ‘Special Resolution Regime’ which gives the UK authorities a number of resolution tools for dealing with distressed banks and building societies

33 ICB, *Interim Report, Consultation on Reform Options*, chapter 4, p76 April 2011

transferred internally to wholesale/investment banking”.<sup>34</sup> The ICB argue that a ring-fence could help tackle the problems identified above by:

- making it easier and less costly to sort out universal banks that get into trouble;
- making the UK system better able to absorb shocks; and
- curtailing perceived government guarantees.

29. We asked the ICB why it has, at this stage, expressed a preference for a retail ring-fence rather than full structural separation. Sir John Vickers told us that it was:

a question about costs and benefits. If the [financial] stability benefits can largely, or almost all, be achieved by way of subsidiarisation—the UK retail ring-fence—if total separation entails much greater economic costs, and we believe it does entail greater costs, then on an analysis of cost and benefits, if you are getting the benefits with the retail ring-fence at lower cost, that is the sensible thing to do.<sup>35</sup>

Sir John acknowledged, however, that there were differences in the financial stability benefits of a ring-fence vis-a-vis full separation. Sir John gave us the argument for a “total split”, using the example of a global crisis where “you could imagine UK retail suffering from contagion if UK retail sits within a wider international group which might not happen if you had total separation”. On the other hand, Sir John used a different scenario to demonstrate situations where a ring-fence could bring greater financial stability benefits than total separation:

one can imagine future crises that are domestic in nature. As I said earlier, retail banking is inherently risky [...]. If you have a retail ring-fence in a wider group, and it is UK retail that is in big trouble, then with a UK retail ring-fence, rather than a total split, the parent can bring resources to rescue UK retail in a way that can’t happen if you have a total split.<sup>36</sup>

He concluded that it was “not obvious which is better from a financial stability point of view”. Bill Winters concurred with Sir John, arguing that the ring-fence satisfied “all the conditions that we consider to be critically important for minimising the impact on the UK economy and the taxpayer from a financial crisis”. He reiterated that full separation also addressed “most of those issues but at substantially higher costs and with some downsides”. As a result:

on balance, our preliminary view—of course, still subject to further investigation—was that the retail ring-fence satisfied our conditions in a way that created the least cost for society.<sup>37</sup>

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34 ICB, *Interim Report, Consultation on Reform Options*, chapter 4, p85 April 2011

35 Q 24

36 *Ibid.*

37 *Ibid.*

## Costs of a ring-fence

30. The ICB Interim Report outlined some of the increased costs universal banks could face as a result of the introduction of a retail ring-fence. The most significant costs cited were:

- the market would require the non-ring-fenced arm of the bank to hold more capital because “pure investment banks tend to have higher capital ratios than universal banks”;
- the cost of the non-ring-fenced arm of the bank’s debt funding would go up. This was because “pure wholesale/investment banks have higher funding costs than universal banks and, depending on the additional capital raised, may have a lower rating”. In addition the ICB said funding costs could rise because “pure wholesale/investment banks may require a higher average term of funding than universal banks”.<sup>38</sup>

31. The Commission concluded that their current view was that “the private costs of a UK retail ring-fence may be material but are likely to be much smaller than the £12–15bn estimate” which had been suggested as the aggregate annual cost to the UK banks.<sup>39</sup> The ICB has also explored the extent to which any private costs might translate into social costs. It has concluded that “wholesale/investment banks would bear the brunt of higher costs”, but given that “these services are traded in international markets”:

The pass-through from increased costs for some producers (UK universal banks) to prices would therefore be limited by the presence of other, unaffected providers (non-banks and foreign banks) in the markets where costs increase the most. So the supply of financial services to UK users—which is what matters for the impact of the ring-fence on the real economy—might not be affected a great deal.

32. Sir John Vickers expanded on the potential costs of the ring-fence when he appeared before us. He stressed that the design of the ring-fence would be crucial to avoid unnecessary economic costs:

The tighter the line is drawn, the higher the fence. There, the real economic costs do start to mount, and I am not talking about cost to the banks; I am talking about cost to society at large. If retail deposits can’t be lent to even very small businesses, there is a real economic cost that will make life much harder for small businesses and will make the returns on savings much lower for households. That is a true cost. It is a balance between that and the stability benefits that we are trying to achieve.<sup>40</sup>

33. We asked the Commissioners whether they had also calculated the cost of full separation. They told us that they had attempted to do this, but had not yet “reached

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38 Other reasons why costs may increase cited by the ICB include the fact that the bank may need to hold additional liquid assets, the bank may lose business or the bank may incur additional operating costs; ICB, *Interim Report, Consultation on Reform Options*, Annex 3, April 2011

39 ICB, *Interim Report, Consultation on Reform Options*, Annex 3, p159, April 2011

40 Q 81

numbers that are robust enough [...] to put out”.<sup>41</sup> Martin Taylor explained why banks, such as Barclays and HSBC, liked to operate within a universal banking structure. He explained that such banks derived three principal benefits from operating a universal banking model—“one is the stability of the retail deposit base; secondly, the diversification of earnings; and thirdly, the implicit guarantee”.<sup>42</sup> The first two benefits listed by Mr Taylor can be described as ‘genuine’ economic benefits, but the third as a transfer payment.

34. Bill Winters described the benefits to the universal banks of a ring-fence rather than full separation:

The overwhelming benefit to the banks of the ring-fence versus complete separation is this diversification benefit, which translates through to capital efficiency, lower capital, and lower funding cost. Of course, our challenge is to separate and observe the lower funding cost between that which comes from diversification—good stuff—and that which comes from subsidy—bad stuff.<sup>43</sup>

Mr Winters’ differentiation between ‘good’ and ‘bad’ stuff refers to the fact that some part of the cost increase banks would face as a result of the introduction of a retail ring-fence would result from a reduction in the strength of any government guarantee and the dilution/elimination of the implicit subsidy. Indeed, the ICB stressed this point in their interim report:

Higher capital and funding costs might arise from a loss of diversification benefit, and/or from a reduction in the strength of any government guarantee. Costs from reduced guarantees and higher tax payments (as equity forms a greater proportion of liabilities) are not social costs of themselves, but rather represent a transfer from banks to taxpayers. Lost diversification benefits, in contrast, do not yield an offsetting reduction in costs elsewhere. The private costs of a ring-fence are likely to be some combination of the two.<sup>44</sup>

35. The banks, however, were unwilling to put a firm figure on the cost of the retail ring-fence at this stage. For example, Stephen Hester explained that:

because the Commission’s proposals have not been finalised, and the international, if you like, regulatory position, which would be the alternative or the extant, you do not have either to completely compare against each other, so I cannot give you a figure [...] Today there are still a thousand flavours of variance within this, it is very hard to give a single number.<sup>45</sup>

36. Subsequently, RBS provided supplementary evidence, which stated they “expected the cost impact of ring-fencing to vary significantly with the detailed parameters that are ultimately established. They argued that cost increases would arise principally from:

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41 Q 30

42 Q 51

43 Q 32

44 ICB, *Interim Report, Consultation on Reform Options*, Annex 3, p159, April 2011

45 Q 185

- Increased funding costs as a result of the partial loss of diversification of assets, earnings and funding arising from ring-fencing.
- Higher capital required to mitigate, at least in part the impact of lost diversification.
- Trapped pools of liquidity within the ring-fenced subsidiary.
- Operating cost synergies should be less affected than they would be in the event of full separation. However, it is anticipated that some cost increases would arise, in addition to the substantial one-off costs of implementation.

The memorandum went on to say that, while it was “difficult to quantify these costs with precision until we have more details on the working of a ring-fence, it may be helpful to bear these orders of magnitude in mind in weighing up the impact of ring-fencing on value”:

- A 0.1% increase in wholesale funding costs would equate to approximately £300m of additional costs per year for RBS.
- A 1% increase in Core Tier 1 capital required would equate to approximately £6bn.
- A 1% erosion of revenues would amount to approximately £300m per year. In practice, costs from ring-fencing would be distributed in some measure across all stakeholder groups, affecting shareholders, customers, tax receipts and employment.<sup>46</sup>

### **The bank reaction to a retail ring-fence**

37. We took evidence on the retail ring-fence from senior executives at the four largest banks—HSBC, RBS, Barclays and Lloyds Banking Group. There were clear differences between the banks about the desirability and practicality of a retail ring-fence, although all stressed that it was difficult to make a comprehensive assessment of the merits or otherwise of a retail ring-fence until the ICB provided far more detail as to the practical design of the ring-fence.

38. Reservations expressed by bank executives about the principle of introducing a ring-fence took a number of forms, including that a ring-fence would:

- entrench the implicit subsidy in retail banks and create the perception that such entities would enjoy Government protection;
- add little or nothing in financial stability terms beyond the panoply of measures already introduced, or in the process of being introduced;
- fail to address the fact that the vast majority of banks who ran into trouble during the financial crisis were domestic banks engaged purely in retail lending;

- be far more costly than operational subsidiarisation, which would achieve the same goal at lower cost.

39. Lloyds Banking Group, the institution which, out of the four, would be least affected by a ring-fence, told us that “subsidiarisation of key UK banking activities within universal banks could bring substantial social benefits”.<sup>47</sup> Mr Horta-Osório, CEO of Lloyds Banking Group, expanded on this before the Committee:

the main advantages of ring-fencing are twofold, which is to protect key economic functions such as retail deposits and payment systems, and secondly to reduce the complexity and inter-connectedness between different parts of a universal bank.

Lloyds argued that “subsidiarisation could also prevent any cross-subsidy from retail to investment banking activities. Ensuring subsidiaries faced a cost of funding and capital that reflected their stand-alone risk profiles would prevent misallocation of economic resources”. Mr Horta-Osório told us that:

I think there is a collateral advantage, which is that you have different parts of the universal bank that can fund on their own feet, on their own merits if you want, on their own risk, and therefore in their own cost of funding, and in my opinion they can keep a universal and integrated approach to clients, given that you still have a holding company. You can still keep the diversification benefit at the holding company level and you approach customers in an integrated way, but separated [way].<sup>48</sup>

Lloyds stressed, however, that “the costs and benefits of subsidiarisation depend crucially on where the division between ‘retail’ and ‘investment’ banking is made”.<sup>49</sup> We discuss this in greater detail later in the chapter.

40. Douglas Flint, Group Chairman, HSBC, when asked whether the UK needed a ring-fence, responded by saying that he could see “given what has happened, why there would be thought given to it”. On being pressed, Mr Flint went further, stating “that while I would prefer that there wasn’t one,” “I think it [a ring-fence] is required”.<sup>50</sup> He explained his reasoning:

Given where we have come from, the principal responsibility of policy makers should be to ensure that the supply of credit to the real economy is uninterrupted through volatile conditions, and I think that the impact on the supply of credit that came from peripheral activities, particularly the securitisation and structured credit markets which impacted the capitalisation of major banks and therefore interrupted the flow of credit because they were capital impaired, was tragic. Therefore, while an enormous number of things have been done to prevent the repetition of what

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47 Ev 63

48 Q 246

49 Ev 63

50 Q 150

happened, I think if I were a policy maker I would seek to set aside the real economy funding capacity from the intra financial sector trading activity.<sup>51</sup>

41. Stephen Hester was much less enthusiastic about a retail ring-fence:

I believe that creating a ring fence increases some of the systemic risk and decreases the ability of banks to withstand the risk and has significant cost to it.<sup>52</sup>

However, when pressed as to whether the increase in risk and cost which he felt would result from a ring-fence meant he was against such a proposal, he replied that the issue was not “black and white” and that given RBS “have lots of subsidiaries [...] I cannot tell you we oppose a subsidiary in principle”.<sup>53</sup> Mr Hester pointed out some of the difficulties with a ring-fence, arguing that it could actually increase “moral hazard” and entrench the implicit government guarantee through creating:

a protected beast that has some sort of overt, “In a crisis, don’t worry; the Government will support you”. Of course those kind of protected beasts, domestic banks, were the source of the vast majority of banks that went bust or nearly went bust—not RBS, I completely grant you—so we need to be careful that we are not creating a ring fence that will contain exactly the things that systemically lost a lot of money: Irish banks, Spanish banks, some of the US banks, Bradford & Bingley, Northern Rock and so on—and giving it a public imprimatur saying, “This is a protected subsidiary that we will support”, that encourages moral hazard while the other parts of banks are made more volatile because you are saying that in no way will you support them.<sup>54</sup>

Subsequently, in its response to the ICB consultation on its interim report, RBS has developed its own ring-fence proposal based on the existing regulatory ring-fencing framework, the UK Defined Liquidity Group (DLG). RBS maintain that their first preference is for no ring-fence, but their variant of the ring-fence, based on liquidity, would they claim, meet the Commission’s objectives and terms of reference more effectively and in a less costly manner than some other variants.

42. The ICB’s work is taking place alongside a host of other initiatives at both international, European and UK level. For example, the Basel Committee on Banking Supervision (BCBS) has come up with proposals to strengthen capital and liquidity requirements, whilst much activity is also taking place at international and UK level examining the framework for recovery and resolution of large complex financial institutions and at seeking to make institutions more resolvable as they approach the point of failure.

43. Mr Hester referred to these initiatives, arguing that it would be “hard to design a ring fence that improves upon the risk-cost balance over and above the other proposals that the

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51 Q 151

52 Q 156

53 Q 186

54 Q 159

Commission is supporting and that are being pursued through Basel and the other worldwide reforms”. He listed some of these proposals:

In terms of the Commission’s proposals, I think that they endorse a number of things we wholeheartedly agree with that are designed to remove implicit subsidies for banks and to allow banks and society to cope with future systemic crises: better liquidity standards; more capital; resolution powers and plans, including the 2009 Banking Act, and indeed any further tweaks that were needed to allow supervisors the huge powers that that gives; and bail-ins to give a source of capital beyond the Government in extremis, one step short of liquidation. I think all of these features are being adopted by the rest of the world, including us through the Basel process.<sup>55</sup>

Mr Hester went on to use the example of reforms contained in the 2009 Banking Act where “regulators can at the point of failure take any bit of any bank and say, That is going down and this bit is not going down, and this is how we are going to deal with it. These are the powers that they have”. He explained that the US authorities now had similar powers which “they used [...] at one point in the last crisis with Washington Mutual”. He also used the example of Bradford and Bingley:

By the way, in a less perfect earlier guise, this was used in Bradford & Bingley. Bradford & Bingley was separated into two at the point of crisis and some bits were kept going and some bits were not. The powers have been greatly improved that are available to the authorities since that occasion, so this is not new stuff, although it has been taken on a great deal further, and I think it is an essential piece of the armoury that will allow us to treat the problems of the future and not to have to imagine them today and perhaps get them wrong.<sup>56</sup>

44. Mr Hester’s point about the risk of entrenching the subsidy was repeated by Mr Diamond who cautioned that “if you take an extreme view of ring-fencing—now, I’m saying an extreme view, and it is not at all clear to me that is where the Independent Commission is—it makes the implied guarantee almost explicit in terms of UK retail deposits”.<sup>57</sup> When pressed as to his understanding of an “extreme” view, Mr Diamond replied that:

“extreme” would be Glass-Steagall; a complete separation of wholesale and retail banking or investment banking and retail banking, however you define it. It is broadly recommended by the Independent Commission that this is not ring-fencing capital; it is ring-fencing deposits. We are working very closely with them so we feel this is a workable solution that doesn’t have a big cost to the economy and doesn’t create an explicit guarantee.<sup>58</sup>

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55 Q 154

56 Q 171

57 Q 273

58 *Ibid.*

45. Barclays told us that “operational subsidiarisation—which would allow critical infrastructure to be segregated legally immediately after a resolution event—could play a material role in ensuring an integrated, cross-border bank is resolvable”. They expressed concern that the ICB had “understated the ability of operational subsidiarisation to address the broader issues that the ICB has suggested could be rectified through so-called ring-fencing”.<sup>59</sup> We asked Mr Diamond whether he envisaged that a ring-fence could be of ‘benefit’. He replied that “it would not be my first choice”. Instead, he outlined his preference for operational subsidiarisation:<sup>60</sup>

how can we know that if a large bank or a small bank—but pick a large bank—got into trouble, let us say, in the derivatives market, the branches could open on Monday morning or Tuesday morning, the small businesses could still operate and the money transmission could operate, and we really believe that subsidiarising by how we operate the business rather than through capital is the appropriate way to go. We absolutely believe that the regulators, if they smell trouble, have to be able to protect the depositors and the small businesses. The way I think of it simply is the branch-based business: the people, the buildings, the technology, the electronics, but the businesses that use the branch area because they tend to not have another alternative. I think our spirit is the same. We are trying to solve the same problem.<sup>61</sup>

## The design of the ring-fence

### *Scope and height of the ring-fence`*

46. The Commission has yet to publish detailed analysis of how a retail ring-fence would operate in practice, and on which activities should fall inside and outside the ring-fence. The ICB will, however, have to make important decisions as to whether any ring-fence should be broad or narrow in its scope, and how high the ring-fence should be. In essence, the scope of the ring-fence refers to those activities which would definitely fall into the ring-fence. For example, a ‘narrow’ ring-fence could comprise, on the liabilities side, merely UK household deposits or, on an even narrower basis, only those household deposits insured under the Financial Services Compensation Scheme (FSCS). The asset side could comprise personal unsecured lending, mortgages, SME lending and parts of the banks’ liquidity pools. Such a ‘ring-fence’ would leave very significant activities outside the ring-fence. By contrast, a wider ring-fence could be composed, for example, of a much broader range of the assets and deposits currently found in UK retail and UK corporate activities. The debate on ‘height’ of the ring-fence meanwhile refers to what transactions could take place between the retail subsidiary and the rest of the organisation.

47. Martin Taylor outlined the main features of the ring-fence:

It is a separation within one organisation. You could have a holding company and you could have a shared brand. You could sell services from both the organisations—

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59 Ev 62

60 Q 250

61 Q 249

both the ring-fenced retail business and the other—to the same customers. Some customers might well be customers for both.<sup>62</sup>

He reiterated that “the ring-fenced organisation would certainly be independently capitalised and have to maintain a certain [level of] capital at all times”. Furthermore, Mr Taylor stressed that the ring-fenced entity would not be able to “pay dividends to its holding company, which would then, of course, be free to put the money into the other side of the business, unless that capital was there, and it would need regulatory approval to make this move”.<sup>63</sup>

48. Bill Winters explained some of the key issues the ICB was considering with respect to the height of the ring-fence:

The dealings between entities within a bank group under our recommendations would be very strictly supervised, and effectively the amount of credit that could be extended from one part of the group, for example a retail ring-fenced entity, to another part of the group would be subject to counterparty limits, as if they were external counterparties. One of the questions we have raised in the report is whether there be any porosity or any ability to move money across these boundaries, and whether the wall should be higher or lower than would be the case for a truly external independent counterparty.<sup>64</sup>

Sir John outlined the ICB’s thinking on the scope of the ring-fence and, in particular, the issue of where derivatives used by banks for hedging purposes would sit:

Take what, by any standard, might be a plain, ordinary retail bank. Say it is doing fixed-rate mortgages and it is financing it largely out of deposits; there will be interest rates risks that it faces. So there are questions about its own use of derivative contracts in hedging its own operations. There I think we can quite usefully look to the building society sector, where the same questions arise and are dealt with in a legislative framework.<sup>65</sup>

49. Prior to our session with the banks, HSBC submitted a memorandum which outlined one possible way to design the ring-fence and which in the words of Douglas Flint “sought to operationalise some of the proposals that the ICB was coming out with in its preliminary thinking”.<sup>66</sup>

50. Under the HSBC approach, the Ring-Fenced Bank (RFB) could be authorised to hold only assets which qualify for accrual accounting under IFRS 9—the amortised cost classified activities. Assets would therefore need to meet the following two criteria to be measured at amortised cost (net of any writedown for impairment):

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62 Q 26

63 Q 28

64 Q 29

65 Q 65

66 Q 149; The memorandum received by the Treasury Committee from HSBC had previously been submitted to the ICB

- Business model test: The objective of the entity's business model is to hold the financial asset to collect the contractual cash flows (rather than to sell the instrument prior to its contractual maturity to realise its fair value changes)
- Cash flow characteristics test: The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal outstanding.<sup>67</sup>

51. Douglas Flint explained the rationale behind his proposals:

The benefit of that is that it is objective, it is auditable, there are clear rules and it effectively gets to, in old terminology, what might have been a banking book versus a trading book. Effectively, the accounting standard says accrual accounted assets can only be those that have originated in the business model, which is for the collection of interest and principal, where there is no complexity to the structure and so on, and therefore there is a clear dividing line between that and assets that are held for the benefit of trading in their value.<sup>68</sup>

When asked where derivatives would sit under his plan, Mr Flint explained that “you need derivatives in the ring fence bank because you would need to be able to hedge interest rate and foreign exchange risk” and went on to use the example of fixed-rate mortgages to illustrate his point:

to provide fixed-rate mortgages, you need to be able to adjust interest rates, so you would get down to what would be like a building society scenario that said that only derivatives that are qualified as hedges of those assets would be admitted into the retail bank, so effectively they are changing the cash flow characteristics of core lending to businesses and individuals, and derivatives that are there for the positioning for value change would not be there. You would have on-balance-sheet lending and derivatives that hedge the characteristics of interest rates and foreign exchange in that model.<sup>69</sup>

Mr Flint went on to describe his preference for a “broad” ring-fence because of the risk that if the ring-fence was very narrow, “you end up with a bank that is rich in deposits and has less lending”.<sup>70</sup> The consequence would be that within a universal bank “you would have one bank with too many deposits lending into the wholesale market and another bank with far too few deposits borrowing from the wholesale market”.

## Regulatory implications of reform

52. In August 2010, the Coalition Government announced the Statement of New Regulation, which included the “One-in, One-out rule”. This rule essentially now means that no new legislation which imposes costs on business can be brought in without the

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67 Ev 80–81

68 Q 152

69 Q 153

70 Q 181

identification of existing regulations with an equivalent value that can be removed. There are a small number of categories of regulation that are exempt from this statement, one of which is “measures designed to address systematic financial risk”. Given the remit of the ICB to “reduc[e] systemic risk in the banking sector” it is likely that their proposals will fall under this exemption. However, we would welcome clarification that this will indeed be the case.

### The ring-fence and other reform options

53. While the ICB has stated that a retail ring-fence is currently its lead option, it has not ruled out other structural reform options, particularly full separation. Indeed, the ICB says that it is currently doing further work on all areas. It could conceivably reject structural reform of whatever shade in favour of an approach based on higher capital requirements and greater use of loss-absorbing debt alone.

54. The ICB has stated that ring-fencing is its lead option at the present time. It has also provided far more detail on this option compared to full separation, operational subsidiarisation or a non-structural approach. For this reason, our questions to the ICB have inevitably focussed on the ring-fence. This does not necessarily mean that a ring-fence is a more problematic solution than the alternatives and neither does it mean that the Committee is endorsing or rejecting a ring-fence.

### Questions for the ICB and the banks

**55. In their Interim Report, the ICB state that, at the present time, they do not plan an approach which would, in the language of the ICB, be laissez-faire about structure and seek to achieve financial stability by very high capital requirements across the board. The ICB must explain why they do not favour this option and how much they assess capital requirements would have had to rise by were this option chosen.**

**56. Full structural separation is not at the present time the ICB’s lead option. This thin treatment by the ICB of full separation, covered in just one page, is not convincing as a demonstration that full consideration has been given to this option. The ICB must explain in greater detail why they came to this decision.**

**57. The ICB told us that a retail ring-fence would achieve “largely, or almost all” the financial stability benefits of full separation. The ICB must clarify what specific and additional financial stability benefits would be achieved by full separation and whether they have quantified the value of these additional benefits.**

**58. The ICB has stated that full structural separation of universal banks remains an option. The ICB should provide some estimates of the costs to the banks of full separation.**

**59. There is concern not only that universal banks benefit from using retail deposits and the implicit subsidy that goes with them to fund more risky investment banking activities, but also that this leads to sub-optimal use of these funds for investment in the real economy. The ICB must assess which reform option would best ensure that**

consumers do not see their savings put at risk in this way and whether the universal model leads to a sub-optimal use of funds for investment in the real economy.

60. There is concern about the impact of some of the structural reform options on the competitiveness of the UK economy as well as on the cost of credit to business. The ICB needs to provide us with more detailed analysis of how the impact on the competitiveness of the UK economy compares between the full separation and the retail ring-fence options as well as the impact of these two reform options on the cost of credit to business.

61. There is much scepticism about whether the ICB proposals would enable the authorities to allow a large complex wholesale bank to fail, and the ICB itself tacitly admits that it might be impossible for a government to let such a bank fail. The ICB provides arguments for proceeding with ring fencing nonetheless. The ICB should demonstrate and explain how their proposals, together with other international reforms, would mean such institutions could be allowed to fail in an orderly manner.

62. The ICB proposals for a ring-fence as yet contain little detail, making it difficult to evaluate the pros and cons of a narrow versus a broad ring-fence. We urge the ICB to come up with a more detailed analysis of the costs and benefits of various forms of ring-fence and with robust estimates of the cost to the banks and the social costs and attempt to secure some measure of agreement with the banks on these figures.

63. The ICB has stated that the increase in costs to the banks will fall largely on the non-ring-fenced entity which would constitute the wholesale/investment banking part of the bank. Clearly there could be significant consequences for the cost of wholesale banking services to its business customers. The ICB needs to conduct further analysis of the impact on the competitiveness of UK universal banks and their ability to compete with other firms in the global marketplace. We also urge the ICB to provide estimates of the likely effects on the cost of credit to businesses, building on the work in Annex 3 of their report.

64. A number of bank executives have expressed concern that a retail ring-fence, far from removing the implicit subsidy, will serve merely to entrench the subsidy and make it explicit within retail banks. The ICB needs to address this criticism.

65. Opponents of a ring-fence allege it will aggravate moral hazard and lead to increased risk-taking within ring-fenced institutions. The ICB must demonstrate why this will not be the case.

66. Stephen Hester and others charge that a retail ring-fence will add little to measures already in train to promote financial stability being undertaken both internationally and in the UK. These include a higher capital levels, tighter liquidity requirements, resolution plans, contingent capital and bail-ins. The ICB needs to explain why these measures are insufficient and a retail ring-fence is essential. It would also be useful if the ICB could explain the inter-relationship between ring-fencing and the other measures, and indicate some of the trade-offs—eg how much more capital would be required in the absence of a ring-fence.

67. Barclays argue that operational subsidiarisation would deliver the same benefits as a retail ring-fence, but at a far lower cost. The ICB must explain more clearly why they believe this would not be the case and outline what specific financial stability benefits would result from a retail ring-fence rather than operational subsidiarisation.

68. One of the justifications for the ring-fence appears to be uncertainty that other measures to make banks readily resolvable would be effective in a crisis. We urge the ICB to outline in greater detail its concerns about the effectiveness of resolution plans. Furthermore, the ICB should explain whether, if it at some point, it became clear that banks had become readily resolvable, the ring-fence requirement should be dropped.

69. Concerns have been raised that the banks will attempt to find ways around any ring-fence and that such a fence risks becoming porous over time. We believe the ICB must undertake further work to identify the key risks in this area and detail what regulatory regime will be necessary to prevent this happening.

70. The ICB has said little thus far on how corporate governance will operate in universal banks with a retail ring-fence. We believe the ICB's final report must address this issue and set out a framework for corporate governance in such institutions. For example, the ICB should say whether it will be permissible for the boards of companies on either side of the ring fence within a single group to have overlapping membership.

71. More generally, the ICB has little to say in its interim report about how corporate governance might be improved in such a way as to improve the stability of the banking system. This is an important omission which we hope will be remedied in the final report.

72. There are concerns that the ring-fence could particularly, over time fail the test of good regulation—i.e. it may be neither simple nor transparent. It appears likely that there will need to be a complex set of rules about what activities are permitted in the ring-fence as well as rules governing transactions between the retail and investment subsidiaries. This may make monitoring compliance difficult and costly particularly in response to innovation in the industry. We urge the ICB to examine the regulatory costs of implementing and monitoring the ring-fence and how it will ensure any ring-fence will be simple and transparent.

## 4 Promoting competition

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### Competition and the new regulatory framework

73. In our inquiry into the reform of financial regulation we considered whether the future Consumer Protection and Markets Authority (since renamed the Financial Conduct Authority) should have a competition remit, and concluded that “The CPMA should have competition as a primary objective. This will benefit consumers directly and indirectly. Not only will there be a greater choice available for consumers, but the transparency which effective competition brings should reduce the need for heavy-handed regulation”.<sup>71</sup> The ICB interim report also stated that it was “important that the FCA should have a clear primary duty to promote competition”, and Sir John reiterated the importance he attached to this when he appeared before the Committee:

Something that is very important, although at one remove from us, is the potential that the Financial Conduct Authority might have if given the right objective and tools in this area. I think the future of competition in UK financial services is highly dependent on how that regulator operates, because it is a new regulatory opportunity that we have not had. Now, because it is at one remove from us, we are not saying, “You have got to do this, this and this,” but we have very strong and clear views about the brief, the remit, and the objectives that the regulator should have.<sup>72</sup>

74. The Government in its response to our report on *Competition and choice in retail banking* reiterated its opposition to giving the FCA competition as a primary objective. Instead it said it had decided:

to impose a duty on the FCA to promote competition, in discharging its general functions in pursuance of any of its operational objectives, unless this would be incompatible with its strategic and operational objectives.

The Government is clear effective competition plays as an important role in protecting consumers. One of the FCA’s operational objectives—facilitating efficiency and choice the market for financial services—is specifically intended to reflect in the FCA’s remit the importance of competitive markets in delivering better outcomes for consumers. The objective captures two crucial elements of competitive markets in delivering better consumer outcomes—efficiency in terms of pricing, supported by an appropriate degree of choice. Therefore this operational objective is framed in such a way as to provide a clear expectation that the FCA should seek to promote competitive markets.<sup>73</sup>

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71 Treasury Committee, Seventh Report of Session 2010–11, *Financial Regulation: a preliminary consideration of the Government’s proposals*, HC 430–I

72 Q 126

73 Treasury Committee, *Competition and choice in retail banking: Government Response to the Ninth Report from the Committee*, Seventh Special Report of Session 2010–12, HC 1408

**75. Both the Treasury Committee and the ICB, which the Government has charged with examining competition in banking, have called for the new Financial Conduct Authority to be given competition as a primary objective. We ask the Government to reconsider its current position in the coming consultation on the legislation.**

### Enhanced Lloyds divestment

76. In 2008, the UK Government, the European Commission and Lloyds Banking Group agreed to a divestiture as one of the remedies to the distortion of competition caused by government support to Lloyds during the financial crisis. Its final approved restructuring plan consists of the divestment of a retail banking business with at least 600 branches, a 4.6% share of the personal current account market in the UK and up to 10% of the Group's mortgage assets. The number of branches to be disposed of represents approximately 20% of the current Lloyds Banking Group network.<sup>74</sup>

The ICB Interim Report recommends that the Government “seek agreement with Lloyds Banking Group to enhance the divestiture substantially”.<sup>75</sup> In making this recommendation, the ICB was implying that the European Commission had misjudged the case.

77. This was justified on the grounds that an “enhanced divestiture could give an improved outcome for competition by strengthening the divestiture's ability to act as a challenger”.<sup>76</sup> The interim report pointed out three major problems with the divestiture as it currently stands:

- the usual challenges facing all new entrants—such as customer inertia, high perceived switching costs;
- fragile balance sheet and weak funding position; and
- being below the scale required to mount an effective competitive challenge to the incumbents (particularly if part of the solution to the funding problem involves shrinking the divestiture further).<sup>77</sup>

The reference to a fragile balance sheet and weak funding position is the currently large gap between loans and deposits in the divested bank—estimated at some £36bn. The concern is that this could force a bank emerging from the divestment either to rely very heavily on wholesale funds or to be forced to shrink its balance sheet to reduce the scale of this mismatch.

78. The ICB has stated that:

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74 ICB, *Interim Report, Consultation on Reform Options*, p119, April 2011

75 *Ibid.*, p122, April 2011

76 The ICB defines a challenger bank as one that has a strong incentive to compete for new market share combined with the ability to be a significant competitive constraint on the major incumbents.

77 ICB, *Interim Report, Consultation on Reform Options*, p122, April 2011

if a substantially enhanced divestiture does not result, there could be a strong case for the competition authorities to conduct a market investigation of the personal banking and SME markets in the UK. This would be in line with the commitment made by the Government in 2008 that the OFT could continue to monitor the impact on competition of the Lloyds TSB/HBOS merger.<sup>78</sup>

79. We asked Sir John about the case for an enhanced divestiture. He began by expressing his regret that the Lloyds/HBOS merger had been allowed to take place:

I think it is very regrettable that it happened and was allowed to happen, not just on competition grounds. I think it was a mistake also on financial stability grounds, because the important thing then was to separate good and bad assets, and unfortunately they got plugged together as a result of that merger, but it happened two and a half years ago, and it is a fact that we confront.<sup>79</sup>

He denied that an ‘enhanced divestiture’ was in effect a reversal of the merger, stating that “we are not proposing specifically that that [the merger] be undone”.<sup>80</sup> Instead Sir John argued that:

we take the view that the scale of divestments arising from the European competition and state aid policy and undertakings around that are not adequate to create the vibrant, competitive force that we think has a much better chance of being created with an enhancement of that divestiture.<sup>81</sup>

However, Sir John appeared unable or unwilling to specify what an ‘enhanced divestiture’ would look like in terms of additional branches etc. He argued it “would have been quite inappropriate to have come out with a numerical view in relation to how many additional Lloyds branches there would be, say, or indeed on the composition, nature or geographical spread of such branches”.<sup>82</sup> When asked whether he had any idea what would constitute an ‘enhanced divestment’, Mr Horta-Osório said he had no idea and that Lloyds did not even know if it was additional branches they were being asked to divest or “another type of assets or type of liabilities”.<sup>83</sup>

80. António Horta-Osório made it clear that he strongly opposed Commission’s view on the need for an ‘enhanced divestiture’:

We have seen no evidence that justifies that divestment. Our board position is very clear on that as we issued on RNS when the preliminary report was published, and our board strongly believes this is against the interests of our customers and therefore against the interests of our shareholders, including the taxpayer.<sup>84</sup>

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78 ICB, *Interim Report, Consultation on Reform Options*, p123, April 2011

79 Q 117

80 *Ibid.*

81 *Ibid.*

82 Q 119

83 Q 260–61

84 Q 252

Mr Horta-Osório argued the initial divestment was sufficient to create a viable challenger bank, stating “it is not only my opinion that this sale presents a serious competitor in the UK market”, but that it was “also the opinion of the European Commission at the time, HMT at the time, and it is the opinion of the bidders at the moment”. Mr Horta-Osório said ‘potential bidders’ such as Virgin Money and NBNK had not expressed concerns about the size or shape of the initial divestment and had not been calling for a further one”.<sup>85</sup> When quizzed about Sir John’s concern that a new challenger bank would have “a fragile balance sheet and a weak funding position”, Mr Horta-Osório replied that:

It is important to note that divestiture evolves in time, and given the dynamics of the UK market, as the mortgage market in net terms is falling and deposits are continuing to increase as banks deleverage, the relationship between assets and liabilities of this bank [the divested entity] is improving over time. By the time that this sale will be completed, which will be around the end of 2013, the loan to deposit ratio of this bank will be in line with other successful banks.<sup>86</sup>

81. One of the major justifications for an ‘enhanced divestment’ is the Commission’s desire to reduce concentration levels in the retail market, which the ICB has said is particularly high in the personal current account and SME markets. Additionally, the ICB has noted that Lloyds Banking Group will remain the clear leader across a number of key retail banking markets even after the divestitures”. Mr Horta-Osório challenged this. He said that “on SMEs, post-sale, we will be number 3, in personal loans we will be number 4, in credit cards we are well behind. Our branches post-sale overall will be 19% of the market, so overall market share will be 20-something % overall”.<sup>87</sup> Mr Horta-Osório went on to describe it as “anomalous” to require Lloyds, with a 25% market share of the current account market, to make an additional divestiture whilst RBS, with a 24% share of the SME market, was not required to take further action.<sup>88</sup> Sir John offered two explanations when we challenged him about the differential treatment being meted out to the two banks. Firstly, he said the RBS divestment had “reached a different stage” and was “essentially was a done deal in the way that the Lloyds one was not”. The second reason he offered was more substantive:

the personal current account market is of particular importance, whether or not one describes personal current accounts as a gateway product. It is a particularly important product for everyday banking services with much wider ramifications. I do think that the prospect of one institution currently with, in round numbers, 30%-even after the Brussels divestment—that is still one in four personal current accounts—is a public policy question of particular importance.<sup>89</sup>

82. Mr Horta-Osório rejected the charge that by proceeding so swiftly with the initial divestment he was hoping to achieve a ‘fait accompli’ which would avoid Lloyds having to

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85 Q 255

86 Q 256

87 Q 259

88 Q 258

89 Q 121

make an additional divestment. He explained that his decision to speed up the process was motivated by a desire to meet the timetable set down by the European Commission and that his experience of the Santander purchase of the RBS divestment had taught him that completing the divestment would take up considerable time.<sup>90</sup>

**83. Lloyds Banking Group has reacted negatively to the ICB’s proposal that it makes an ‘enhanced divestiture’. The key argument appears to revolve around whether the divestment as it stands will lead to the creation of a viable challenger bank. The ICB is concerned about the fragile balance sheet and weak funding position of such an entity, a position which Lloyds—who have argued that the divested bank will be in a far stronger funding position by 2013—rejects. One proof of this will be how many bidders emerge for the divested Lloyds assets.**

**84. We believe further work is required to assess whether the initial standalone divestment is sufficient to create a viable challenger bank. If so, we believe that Sir John should consider whether an enhanced divestment is really necessary and whether by calling for such a step the ICB is treating the symptom of inadequate competition rather than the cause.**

**85. The ICB should also confirm whether it has examined the case for further divestments of branches from other banks.**

## Switching and transparency

86. Mr Horta-Osório questioned the ICB’s decision to focus on an ‘enhanced divestiture’ rather than on switching and transparency. He argued that these “two pillars” were key to a competitive retail market:

The first [...] is an easier switching process. There has been progress made in terms of customers being able to switch effectively and without risk, but more progress can be made. We are proposing a seven-day automated redirection of direct debits whereby customers in seven days can be sure that their account and their direct debits are automatically redirected to the new account without any risk. All banks have now endorsed that solution and the Payments Council as well. That can be implemented in two years and has much lower costs and a much shorter timeframe than account portability, for example.

The second pillar is more transparency. Transparency, together with the ability of changing providers in any sector, if the customer is not happy, is what drives competition. It is not mandatorily asking customers to change banks. In terms of transparency, we strongly believe, as we proposed to the ICB and we gave you evidence, that we could have simple statements whereby customers can see the opportunity costs of holding their money in their current accounts. We think that the simplest example would be to have it versus base rate. Of course, base rates now are very low—0.5%—but three years ago it was 4% or 5%, so it would be much more

significant, and you could also use other examples. But base rate is a rate which is in the markets. It's an official rate, and customers could see what their opportunity costs are versus the service and benefits from their current account.<sup>91</sup>

Lloyds expanded on this in written evidence. They went on to argue “that improving both switching and transparency would further enhance competition in the market”. They went on to argue that “a world-leading current account switching service could be introduced within two to three years”. Their proposed new system would provide an automatic, guaranteed and fast, seven day switching service for personal and business current accounts, which would Lloyds believe “be seamless and error-free from the customers' perspective”. It would involve an automated account redirection service so that when a customer switches account provider, all direct debits, standing orders and credits are made from and to the correct account. Lloyds also discussed other options for delivering improved switching, including an assessment of the costs and timeframes of delivering full account number portability. They concluded that:

full account number portability would take much longer to implement (between five and ten years), cost significantly more and would not offer significant additional customer benefits. Indeed, in practice, full account portability would not involve instantaneous (or same day) switching. Providers would have to put in place appropriate processes to protect customers against erroneous or fraudulent attempts to switch their account.<sup>92,93</sup>

87. In April 2011 the Treasury Committee published a Report on competition and choice in retail banking. We concluded that:

further measures are required to promote competition in the retail banking sector and ensure improved outcomes for consumers. Poor consumer outcomes can be addressed by reducing barriers to entry and expansion—in order to promote greater competition between existing players and to encourage new entry. A focus on tackling concentration without tackling these issues would do little to promote a more competitive market. New and expanding entrants will only succeed in growing in key markets, such as the current account and SME markets, if impediments to their expansion—primarily problems with switching and the lack of transparency and comparability—are tackled.<sup>94</sup>

88. The ICB has also identified “the actual and perceived difficulties for customers switching accounts” as ‘blunting’ competition in the retail banking market. They argue that further improvements could speed the [switching] process and give customers (both personal and business) greater confidence in switching”, but also note that this “would need to be accompanied by greater transparency so that customers can better compare the

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91 Q 267

92 These options to improve the switching process are outlined in greater detail in a Lloyds submission to the ICB which they have also sent to the Treasury Committee.

93 Ev 66–69

94 Treasury Committee, *Competition and choice in retail banking: Government Response to the Ninth Report from the Committee*, Seventh Special Report of Session 2010–12, HC1408, p83, para 223

products on offer”. The ICB have set out some options for improving the switching process, namely that:

- The switching process could be improved in the short term by mandating a set time period within which banks would guarantee that the switch could be completed;
- Over a longer time period—one to two years—the possible creation of a redirection system to transfer debits and credits from the old (closed) account automatically to the new account;
- Or full account portability— which would enable consumers to change banking service providers without changing their bank account number. This would remove the need to transfer direct debits and standing orders which as the ICB notes remains the main area where problems may arise with the switching process.

89. On measures to improve transparency, the ICB has noted that “although interest foregone on positive account balances is one of the key sources of customer cost, this element of cost is not visible to the customer”. Beyond this, the ICB has merely said that it would welcome evidence on “additional improvements that would make it easier to compare accounts on offer”.<sup>95</sup>

**90. In total the ICB has devoted just one page of its interim report to measures to improve the switching process and enhance transparency. Their proposals on switching and transparency of charges to the customer need further development; indeed the interim report does not move forward the debate on this crucially important issue. We urge the ICB to devote sufficient attention and resources to switching and transparency and, to this end, to work more closely with industry, consumer groups and other relevant bodies.**

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<sup>95</sup> ICB, *Interim Report, Consultation on Reform Options*, p123–24, April 2011

# Conclusions and recommendations

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## Introduction

1. The ICB has not yet come down in favour of either full separation, a retail ring-fence or, indeed, what it describes as a *laissez-faire* approach based on higher capital levels. Much greater detail is required on the work already done by the ICB on all these options. This should be made available at the time that the ICB is in a position to make a final set of recommendations. We are concerned that the option of full structural separation has not received sufficient analysis. To this end, we call on the ICB to provide further details as to the costs and benefits of this reform option and why it decided early against full separation when settling its lead option at the time of publication of the interim report. (Paragraph 5)
2. Two areas which the ICB has not yet looked at are, first, the implications of its proposals for the conduct of corporate governance in banks, particularly given the passive shareholder response to the financial crisis, in spite of the significant damage to shareholder returns. Secondly, the regulatory arrangements for policing the ring-fence need careful explanation. We call on the ICB to do further work in both these areas ahead of the publication of their final report. (Paragraph 6)
3. The debate on the merits or otherwise of the ICB proposals must take place openly and transparently in the public eye. The banks must place their objections and concerns fully into the public domain. That said, we have recently seen encouraging signs that some of the large banks have become more willing to share their views with the Treasury Committee. The taxpayer deserves a full and public debate about the future direction and shape of our banking system. A final ICB report based on private discussion and agreement with the banks rather than rigorous public scrutiny would lack public credibility and acceptability. (Paragraph 8)
4. The Committee has not attempted to reach a definitive view on the ICB's Interim proposals, since the ICB report is an interim one. We focus in this report on key questions which we think the ICB needs to address in its final report as well as issues on which we believe it is necessary for the ICB to secure some measure of agreement with the affected banks. Given that the ICB has proposed a retail ring-fence as its lead option our inquiry has focussed on this option. The Committee will examine carefully the ICB's final recommendations and may express a view at that time. (Paragraph 9)

## Government guarantee and implicit subsidy

5. Much of our inquiry on the ICB Interim Report has focussed on the size of the implicit subsidy to the banking sector. The ICB, using the research of others, places the figure at considerably in excess of £10bn, but has not published detailed analysis as to how it arrived at this figure. The banks meanwhile have been reluctant or unable to come up with any credible figures. We have concluded there is an implicit subsidy. There is a need for at least some measure of agreement between the banks and the ICB about the minimum size of the implicit subsidy, now and in the past, as

well as an agreed analytical framework for measuring the subsidy. The need for consensus in this area is critical because of the ICB's goal, shared by the large banks, to eliminate this subsidy. Without an agreed framework for measuring the size of the subsidy it will be difficult to assess when success in this area has been achieved. (Paragraph 22)

6. Our inquiry has focussed on who the major beneficiaries—shareholders, employees, customers—within the banks of this implicit subsidy are, but has not succeeded in eliciting a clear answer. The ICB needs to do further analysis to identify the link between the implicit subsidy and high levels of remuneration for certain activities within banks. Otherwise the link between the implicit subsidy and high levels of remuneration in certain parts of the sector will remain a matter of enduring concern. (Paragraph 23)

### Structural reform options to promote financial stability

7. In their Interim Report, the ICB state that, at the present time, they do not plan an approach which would, in the language of the ICB, be *laissez-faire* about structure and seek to achieve financial stability by very high capital requirements across the board. The ICB must explain why they do not favour this option and how much they assess capital requirements would have had to rise by were this option chosen. (Paragraph 55)
8. Full structural separation is not at the present time the ICB's lead option. This thin treatment by the ICB of full separation, covered in just one page, is not convincing as a demonstration that full consideration has been given to this option. The ICB must explain in greater detail why they came to this decision. (Paragraph 56)
9. The ICB told us that a retail ring-fence would achieve "largely, or almost all" the financial stability benefits of full separation. The ICB must clarify what specific and additional financial stability benefits would be achieved by full separation and whether they have quantified the value of these additional benefits. (Paragraph 57)
10. The ICB has stated that full structural separation of universal banks remains an option. The ICB should provide some estimates of the costs to the banks of full separation. (Paragraph 58)
11. There is concern not only that universal banks benefit from using retail deposits and the implicit subsidy that goes with them to fund more risky investment banking activities, but also that this leads to sub-optimal use of these funds for investment in the real economy. The ICB must assess which reform option would best ensure that consumers do not see their savings put at risk in this way and whether the universal model leads to a sub-optimal use of funds for investment in the real economy. (Paragraph 59)
12. There is concern about the impact of some of the structural reform options on the competitiveness of the UK economy as well as on the cost of credit to business. The ICB needs to provide us with more detailed analysis of how the impact on the competitiveness of the UK economy compares between the full separation and the

retail ring-fence options as well as the impact of these two reform options on the cost of credit to business. (Paragraph 60)

13. There is much scepticism about whether the ICB proposals would enable the authorities to allow a large complex wholesale bank to fail, and the ICB itself tacitly admits that it might be impossible for a government to let such a bank fail. The ICB provides arguments for proceeding with ring fencing nonetheless. The ICB should demonstrate and explain how their proposals, together with other international reforms, would mean such institutions could be allowed to fail in an orderly manner. (Paragraph 61)
14. The ICB proposals for a ring-fence as yet contain little detail, making it difficult to evaluate the pros and cons of a narrow versus a broad ring-fence. We urge the ICB to come up with a more detailed analysis of the costs and benefits of various forms of ring-fence and with robust estimates of the cost to the banks and the social costs and attempt to secure some measure of agreement with the banks on these figures. (Paragraph 62)
15. The ICB has stated that the increase in costs to the banks will fall largely on the non-ring-fenced entity which would constitute the wholesale/investment banking part of the bank. Clearly there could be significant consequences for the cost of wholesale banking services to its business customers. The ICB needs to conduct further analysis of the impact on the competitiveness of UK universal banks and their ability to compete with other firms in the global marketplace. We also urge the ICB to provide estimates of the likely effects on the cost of credit to businesses, building on the work in Annex 3 of their report. (Paragraph 63)
16. A number of bank executives have expressed concern that a retail ring-fence, far from removing the implicit subsidy, will serve merely to entrench the subsidy and make it explicit within retail banks. The ICB needs to address this criticism. (Paragraph 64)
17. Opponents of a ring-fence allege it will aggravate moral hazard and lead to increased risk-taking within ring-fenced institutions. The ICB must demonstrate why this will not be the case. (Paragraph 65)
18. Stephen Hester and others charge that a retail ring-fence will add little to measures already in train to promote financial stability being undertaken both internationally and in the UK. These include a higher capital levels, tighter liquidity requirements, resolution plans, contingent capital and bail-ins. The ICB needs to explain why these measures are insufficient and a retail ring-fence is essential. It would also be useful if the ICB could explain the inter-relationship between ring-fencing and the other measures, and indicate some of the trade-offs—eg how much more capital would be required in the absence of a ring-fence. (Paragraph 66)
19. Barclays argue that operational subsidiarisation would deliver the same benefits as a retail ring-fence, but at a far lower cost. The ICB must explain more clearly why they believe this would not be the case and outline what specific financial stability benefits would result from a retail ring-fence rather than operational subsidiarisation. (Paragraph 67)

20. One of the justifications for the ring-fence appears to be uncertainty that other measures to make banks readily resolvable would be effective in a crisis. We urge the ICB to outline in greater detail its concerns about the effectiveness of resolution plans. Furthermore, the ICB should explain whether, if it at some point, it became clear that banks had become readily resolvable, the ring-fence requirement should be dropped. (Paragraph 68)
21. Concerns have been raised that the banks will attempt to find ways around any ring-fence and that such a fence risks becoming porous over time. We believe the ICB must undertake further work to identify the key risks in this area and detail what regulatory regime will be necessary to prevent this happening. (Paragraph 69)
22. The ICB has said little thus far on how corporate governance will operate in universal banks with a retail ring-fence. We believe the ICB's final report must address this issue and set out a framework for corporate governance in such institutions. For example, the ICB should say whether it will be permissible for the boards of companies on either side of the ring fence within a single group to have overlapping membership. (Paragraph 70)
23. More generally, the ICB has little to say in its interim report about how corporate governance might be improved in such a way as to improve the stability of the banking system. This is an important omission which we hope will be remedied in the final report. (Paragraph 71)
24. There are concerns that the ring-fence could particularly, over time fail the test of good regulation—i.e. it may be neither simple nor transparent. It appears likely that there will need to be a complex set of rules about what activities are permitted in the ring-fence as well as rules governing transactions between the retail and investment subsidiaries. This may make monitoring compliance difficult and costly particularly in response to innovation in the industry. We urge the ICB to examine the regulatory costs of implementing and monitoring the ring-fence and how it will ensure any ring-fence will be simple and transparent. (Paragraph 72)

### Promoting competition

25. Both the Treasury Committee and the ICB, which the Government has charged with examining competition in banking, have called for the new Financial Conduct Authority to be given competition as a primary objective. We ask the Government to reconsider its current position in the coming consultation on the legislation. (Paragraph 75)
26. Lloyds Banking Group has reacted negatively to the ICB's proposal that it makes an 'enhanced divestiture'. The key argument appears to revolve around whether the divestment as it stands will lead to the creation of a viable challenger bank. The ICB is concerned about the fragile balance sheet and weak funding position of such an entity, a position which Lloyds—who have argued that the divested bank will be in a far stronger funding position by 2013—rejects. One proof of this will be how many bidders emerge for the divested Lloyds assets. (Paragraph 83)

27. We believe further work is required to assess whether the initial standalone divestment is sufficient to create a viable challenger bank. If so, we believe that Sir John should consider whether an enhanced divestment is really necessary and whether by calling for such a step the ICB is treating the symptom of inadequate competition rather than the cause. (Paragraph 84)
28. The ICB should also confirm whether it has examined the case for further divestments of branches from other banks. (Paragraph 85)
29. In total the ICB has devoted just one page of its interim report to measures to improve the switching process and enhance transparency. Their proposals on switching and transparency of charges to the customer need further development; indeed the interim report does not move forward the debate on this crucially important issue. We urge the ICB to devote sufficient attention and resources to switching and transparency and, to this end, to work more closely with industry, consumer groups and other relevant bodies. (Paragraph 90)

# Formal Minutes

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**Tuesday 19 July 2011**

Members present:

Mr Andrew Tyrie, in the Chair

Michael Fallon  
Mark Garnier  
Stewart Hosie  
Andrea Leadsom

Mr Andrew Love  
John Mann  
Mr George Mudie

Draft Report (*Independent Commission on Banking*, proposed by the Chair, brought up and read.

*Ordered*, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 90 read and agreed to.

Summary agreed to.

*Resolved*, That the Report be the Nineteenth Report of the Committee to the House.

*Ordered*, That the Chair make the Report to the House.

Written evidence was ordered to be reported to the House for printing with the Report.

[Adjourned till Tuesday 6 September at 9.45 am

## Witnesses

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### Tuesday 24 May 2011

Page

**Sir John Vickers**, Chairman, **Martin Taylor**, Member, and **Bill Winters**, Member, Independent Commission on Banking

Ev 1

### Wednesday 8 June 2011

**Stephen Hester**, Chief Executive, Royal Bank of Scotland, and **Douglas Flint**, Group Chairman, HSBC

Ev 27

**Mr Bob Diamond**, Chief Executive, Barclays, and **Mr António Horta-Osório**, Chief Executive, Lloyds Banking Group

Ev 42

## List of printed written evidence

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1	Jayne-Anne Gadhia, Chief Executive, Virtin Money	Ev 58, 59
2	Which?	Ev 59
3	Barclays	Ev 61
4	Lloyds Banking Group	Ev 63
5	HSBC	Ev 80, 84
6	Independent Commission on Banking	Ev 82
7	Royal Bank of Scotland	Ev 85

# List of Reports from the Committee during the current Parliament

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## Session 2010–12

First Report	June 2010 Budget	HC 350
Second Report	Appointment of Dr Martin Weale to the Monetary Policy Committee of the Bank of England	HC 195
Third Report	Appointment of Robert Chote as Chair of the Office for Budget Responsibility	HC 476
Fourth Report	Office for Budget Responsibility	HC 385
Fifth Report	Appointments to the Budget Responsibility Committee	HC 545
Sixth Report	Spending Review 2010	HC 544
Seventh Report	Financial Regulation: a preliminary consideration of the Government's proposals	HC 430
Eighth Report	Principles of tax policy	HC 753
Ninth Report	Competition and Choice in Retail Banking	HC 612
Tenth Report	Budget 2011	HC 897
Eleventh Report	Finance (No.3) Bill	HC 497
Twelfth Report	Appointment of Dr Ben Broadbent to the monetary Policy Committee of the Bank of England	HC 1051
Thirteenth Report	Appointment of Dr Donald Kohn to the interim Financial Policy Committee	HC 1052
Fourteenth Report	Appointments of Michael Cohrs and Alastair Clark to the interim Financial Policy Committee	HC 1125
Fifteenth Report	Retail Distribution Review	HC 857
Sixteenth Report	Administration and effectiveness of HM Revenue and Customs	HC 731
Seventeenth Report	Private Finance Initiative	HC 1146
Eighteenth Report	The future of cheques	HC 1147