



4 July 2011

## **Response to the Independent Commission on Banking: Interim Report**

London First welcomes the opportunity to respond to the Commission's Interim Report. London First is a business membership organisation representing around 200 of London's leading employers from across the business sectors, including financial services. Our response considers the potential impact of the report's recommendations from a broad business perspective, with an additional focus on how any changes will affect London's attractiveness as a global business centre.

The business community wants a stable and competitive financial services sector. This requires the regulatory environment to deliver predictability and transparency in the provision of finance, as well as the freedom and flexibility for banks to provide the investment, products and services that their customers demand. At a time when private sector growth is essential to the UK's recovery, it is vital that regulatory changes do not unnecessarily restrict the ability or attractiveness for banks to finance business.

Many international businesses choose to locate in London because of the breadth and depth of London's financial markets; the access they provide to global markets; and the range of competitively priced products a concentrated financial services market provides. When considering the need for regulatory change it is vital to assess how changes in the regulation of the banking sector will affect the price, range and availability of the financial products and services relied on by business; and the attractiveness of London and the UK as a location for business to invest and grow.

### Recognition of comments to the Commission's Issues Paper

London First is pleased to note that a number of the concerns we raised in our response to the Commission's issues paper have been acknowledged in the interim report, for example:

- the need to assess any proposed regulatory changes in light of current or proposed regulatory regimes in other financial jurisdictions;
- the need to consider additional regulation against the changes already proposed for the UK market (at a UK, EU and international level);
- the importance of considering the costs to business of increased regulation against the intended improvements in financial stability;
- the importance of considering the UK's competitiveness when proposing new action, particularly when it is unilateral.

However, while the interim report has considered the points raised above we remain concerned about both the analytical approach and a number of recommendations.

### Analytical framework

The interim report recognises the need to consider the UK's competitiveness as part of the review of banking regulation; however, insufficient weight is applied to this factor and, in particular, to the international role played by London's financial services market. In the drive towards a more robust regulatory framework, a rigorous cost benefit analysis should be undertaken in which UK competitiveness is a main objective. This will ensure the needs of business, and hence the UK economy, are adequately reflected. The current proposed objectives (stability and competition) should support UK competitiveness. Stability brings competitive advantages through providing an environment that encourages long term investment and growth; and competition provides the stimulus for innovation in product and service development and the drive towards service improvements.

#### Reform options – financial stability

##### *Additional equity requirements*

Changes which minimise the risk of sudden contractions of finance or unexpected changes in terms and conditions (as occurred in the immediate aftermath of the credit crisis) will be welcomed by business. However, these benefits need to be considered against the costs of a permanent reduction in credit availability and an increase in the cost of finance associated with any permanent rise in equity requirements. At a time when concerns are already being raised regarding the cost of finance and the need for banks to play their role in supporting UK growth, it is unclear whether the additional equity requirements will provide sufficient stability improvements to warrant the potential cost.

The report suggests a 10% common equity tier 1 (CET1) ratio; 3 percentage points higher than the rate proposed in Basel III. This potentially unilaterally imposed higher rate is based on the banks having debt which is effectively loss-absorbing, a situation that is not yet certain (see below). We are concerned that the commission will increase even further the CET1 recommendation if it believes that insufficient loss-absorbing debt has been retained by the banks. This would create an even greater gap between the UK and other jurisdictions and would further increase the potential damage to the UK economy.

##### *Systemically important financial institutions ("SIFIs")*

Improvements in the ability of supervisors and analysts to accurately assess and monitor the exposure of any financial institution to systemic risk combined with greater transparency on the potential risks faced by institutions and the risks associated with certain sectors or asset classes within the financial community would result in a lesser rather than greater need for equity. However, as has been shown by the recent crisis, the ability of both the supervisors and the market to accurately assess risk, and in particular systemic risk, is insufficient.

From a business perspective, whilst businesses should be expected to assess the credit worthiness of an individual institution, information asymmetries and inadequate risk information make it unlikely that a business will be able to accurately assess an institution's systemic exposure. Businesses' desire for stability in the financial provision over the economic cycle combined with the limited information available, means there are arguments for SIFIs to hold greater equity than non-SIFIs so as to limit the risk of contagion across the system. However, given the Financial Stability Board is currently looking in to this issue it would be sensible to wait for their outcome before moving forward with any recommendations.

While a surcharge may be necessary (and we would need to see further evidence to fully assess whether this is the case), SIFIs tend to operate cross-border and therefore the value of any surcharge will only be effective if it also applies cross-border. If the UK takes unilateral action it risks damaging the UK's competitiveness and pushing financial institutions offshore. At the same time, unilateral actions will still leave the UK exposed to the failure of non-UK SIFIs. In this respect we welcome the report's recognition that no additional charge should be placed on wholesale and investment banking operations without international agreement.

#### *UK retail banks*

We do not support a unilateral increase in the equity requirements placed on UK retail banking operations (although there is an argument to suggest that any increase in collateral to be held against retail operations would offset the need for a SIFI surcharge). Any such action would risk the attractiveness of retail operations to UK banks and potentially result in higher costs to the end user.

Imposing greater costs on UK retail banking operations compared to retail operations operated in the UK by non-UK entities will make UK retail banking uncompetitive and risk pushing the ownership of UK retail operations offshore. Whilst this in itself may not reduce the service provided to UK retail customers and may not have a major impact on UK employment in this sector, it will push the management and decision making offshore which will result in a loss of tax revenues and a gravitation away from London and the UK in terms of skills and influence over retail investment strategy. While the Treasury may argue that such a shift would reduce the risk of a call on the UK tax payer in the event of a crisis, it is unclear whether the failure of a non-UK bank holding UK retail deposits would occur without cost to the UK taxpayer.

#### *Increasing loss absorbing debt*

Whilst supportive in principle of bank debt being more loss-absorbing, we are concerned about the availability and market for such contingent capital or bail-in products. This is not just a timing issue. Whilst it can be anticipated that the demand for these products will over time be met by supply, it is important that such markets are deep and liquid. Without market liquidity, both availability and price will become an ongoing issue, especially at times of high demand. This could result in banks contracting their balance sheets when they would have otherwise expanded due to a fear of the market reaction to depletion in their loss absorbing debt ratios. This would have a direct impact on businesses and other users of financial products which would suffer the loss of availability and potential increases in costs.

To assess this idea more fully, further evidence needs to be provided on the market for such products.

#### *UK retail ring fence*

As set out in our response to the Commission's issues paper, we did not support the structural break-up of universal banks and we agree with the Commission's analysis that the costs of full separation outweigh the benefits.

The report's suggestion of a ring fence around retail operations is an improvement on full separation. However, it still raises a number of concerns regarding the extent of any ring fence, the practical issues its imposition may cause and the consequences of ring fencing on availability and price of retail bank finance.

The report lacks detail about what is and isn't included in the ring fence and hence more detail is required in order to make a full assessment. Retail deposits are an important funding source for banks. Against these deposits, banks are able to provide long term financing solutions to businesses and other clients. Ring fencing retail operations could reduce the pool of funding available for banks to support their broader business activities, restricting product availability and potentially increasing the price of finance to business.

We agree that ring fencing certain activities should make them easier to separate in the event of the institution's failure, however other approaches such as the requirement for resolution and recovery plans can and have been taken to ensure aspects of a bank can be sold off in the event of a crisis in order to protect the core activities. It is not clear that ring fencing will provide the additional stability benefits, above and beyond those already in place, to warrant the loss of credit availability.

Given the uncertainties surrounding the practicalities and potential cost of a ring fence, and in light of the Government's supportive comments regarding this proposal, we would urge the Commission to ensure a full impact analysis is implemented before any further action is taken.

#### *Timeframe*

Any changes need to have a timeframe that will provide banks with the necessary space to ensure a smooth operational implementation and enable them to take into account the anticipated regulatory changes from the EU and other international bodies. Ensuring a co-ordinated framework should prevent unnecessary duplication of resource and also provide a more predictable transition.

When considering the time frame it is not sufficient to just consider the dates set by regulators. The market response must also be considered. A long regulatory timeframe is irrelevant if the market demands a much quicker response.

#### Reform options - competition

As we set out in our response to the issues paper, there is insufficient evidence to conclude that the UK retail banking market is uncompetitive. There are some markets such as small business lending and personal accounts, that are more concentrated than others but this does not necessarily result in a loss of competitiveness. There are a number of large, national providers competing in both products and the divestment by Lloyds will create a new, significant national competitor. We are encouraged to see reports of new entrants into the retail banking market such as Tesco bank and Virgin bank.

The report's proposals to improve the process of switching accounts and reduce barriers to entry are welcome. This will remove the perception that switching current accounts is difficult or likely to go wrong and make it easier for business and personal customers to switch accounts quickly and confidently. This will make these markets more competitive and

give customers the ability to move in large numbers, as they do in other industries with trusted switching processes, if any bank is offering uncompetitive prices or service.

### Conclusion

We welcome the Commission's interim report as a step in the right direction. However, we remain concerned by the apparently low weighting applied to issues of UK competitiveness and the continued suggestions of unilateral action. The impact regulation could have on London's pre eminence as a leading international financial centre must be fully considered. At a time when private sector growth is vital to the UK's recovery it is important to ensure that the regulation of the UK banking sector does not hinder growth. Should you wish to discuss any of the issues raised in this response further, please do not hesitate to contact Jane Archer on 020 7665 1426 or [jarcher@londonfirst.co.uk](mailto:jarcher@londonfirst.co.uk)