Independent Commission on Banking

Final Report Publication
12 September 2010
Opening Remarks
Sir John Vickers

Good morning and welcome. I plan to spend about fifteen minutes explaining the recommendations in today's *Final Report*. Then we will have up to an hour for questions.

Since publishing our *Interim Report* in April, we have received 170 further consultation responses, we have held more hearings with banks and others, and we have taken part in public events in Edinburgh and London. We have also undertaken a good deal of analytical work, for example on ring-fence design and cost-benefit analysis of reforms.

Over the summer there have also been important regulatory developments from Basel and Brussels. And against a backdrop of sovereign debt problems and general economic weakness, banks have been under renewed strain – I shall return to this point. It underlines that the status quo is not an option: things have got to change.

Aims

Our recommendations aim to create a more stable and competitive basis for UK banking for the long term. That means a banking system that:

- is much less likely to cause, or succumb to, financial crises and the huge costs they bring;
- is self-reliant, so that the taxpayer is never again on the hook for losses that banks make; and
- is effective and efficient at providing the basic banking services of safeguarding retail deposits, operating secure payments systems, and efficiently channelling savings to productive investments in the economy.

Financial stability

The first thing to say about our final recommendations to promote financial stability is that they are squarely in line with the provisional position set out in our *Interim Report*.

Future stability requires that UK banks should have more equity capital and loss-absorbing debt – beyond what has so far been internationally agreed – and that their retail banking activities should be structurally separated, by a ring-fence, from wholesale and investment banking activities. As many have commented, the big question is how.

Structural separation would bring three main benefits:

- it would help insulate vital UK retail banking services from global financial shocks, which is of particular importance given the way that major UK banks combine retail banking with global wholesale/investment banking;
- it would make it easier and less costly to sort out banks – whether retail or investment banks – that still got into trouble despite greater loss-absorbing capacity. This is all part of getting taxpayers off the hook for the banks; and
- it would be good for competitiveness because UK retail banking can be made safer while international standards apply to the global wholesale and investment banking activities of UK banks.

So why not go for total separation? Because a strong ring-fence can get the same, if not more, stability benefits at much lower economic cost. In particular, if one part of the bank is doing well, it can still support the other.

We are recommending a strong ring-fence – otherwise there would be little point in having one – but also a flexible one. This in essence is how it would work.

- <u>Only</u> ring-fenced banks would supply the core domestic retail banking services of taking deposits from ordinary individuals and SMEs and providing them with overdrafts.
- Ring-fenced banks could <u>not</u> undertake trading or markets business, or do derivatives (other than hedging retail risks) or supply services to overseas (in the sense of non-European) customers, or services (other than payments services) resulting in exposures to financial companies.

- Other activities – such as lending to large domestic non-financial companies – would be allowed either side of the fence.

The aggregate balance sheet of UK banks exceeds £6 trillion – more than four times annual UK output. On the basis above, between a sixth and a third of the balance sheet would be inside the fence.

Ring-fenced banks could be self-standing, or subsidiary companies in wider banking groups. They would have their own capital, which could not be depleted below safe limits, and governance arrangements to ensure independence. To protect the integrity of the ring-fence, their dealings with other parts of their banking group would be limited to those generally permissible between third parties.

As well as helping insulate UK retail banking from global shocks, ring-fencing would provide a sound long-term framework for the supply of credit in the economy. In particular, retail deposits – now around £1 trillion – would fund loans to households and businesses in the domestic economy, not investment banking.

The other element of reform for financial stability concerns the ability of banks, especially those of systemic importance, to bear losses. On this our main recommendations are:

- that large ring-fenced banks should have equity capital of at least 10% of risk-weighted assets and corresponding limits on overall leverage;
- that the retail and other activities of large banks should have primary loss-absorbing capacity – equity plus long-term unsecured debt (‘bail-in bonds’) that readily bears loss at the point of failure – of 17%-20% of risk-weighted assets. Remaining unsecured debt should also bear loss on failure if necessary; and
- depositor preference, so that insured deposits rank above all other unsecured debt.

There is a strong case for higher capital requirements internationally than we propose for UK banks, and without ring-fencing we would have recommended substantially higher levels. As with our proposals as a whole, however, we have taken full account of UK competitiveness in the context of international regulation, and of transitional issues. Our recommendations reinforce and go substantially beyond other reform initiatives under way, and we have had careful regard to their cumulative impact.

Our financial stability proposals may increase some banks' costs of capital and unsecured debt, especially outside the ring-fence. But that is largely a consequence of returning risk-bearing to where it should be – with investors and not taxpayers. This is a benefit, not a cost, to the economy as a whole, and will better discipline risk-taking.

That said, improved financial stability does not come for free. But its costs are greatly outweighed by the gains of fewer crises, less damaging crises, and a healthier environment for investment in the UK economy. Just as financial stability benefits the economy overall, it is good for the City too. A more stable domestic banking system will underpin, not jeopardise, the competitiveness of the UK as an international financial centre.

Competition

Our competition recommendations are also in accord with the *Interim Report*. Competition in UK retail banking has not been properly effective. Markets for personal current accounts and SME banking services are concentrated, the more so since the crisis, which saw challengers to the large incumbents fail or be taken over. Conditions for well-informed customer choice are not good, in part because of difficulties of switching between banks. Some competition has been misdirected – to exploit lack of consumer awareness or poor financial regulation. And the implicit government guarantee favours larger banks.

Our financial stability proposals address this last point. Our other main competition recommendations are:

- that the Government seeks agreement with Lloyds to ensure that the divestiture that is under way leads to the emergence of a strong challenger bank. This is not likely to happen with the divestiture as it stands, in view of its prospective share of personal current accounts and large funding gap;

- the introduction within two years of a switching system based on redirection for personal and small business current accounts. This would provide customers with a seamless switching service free of cost and risk. This should be complemented by measures to enhance transparency so that customers can make well-informed choices about the services that best meet their banking needs; and
- that competition is made central to financial regulation by giving the new Financial Conduct Authority a clear duty to promote effective competition. Among other things this would give the necessary impetus to efforts to promote transparency and tackle barriers to entry and growth by rivals to the incumbents.

We are not at this point recommending that markets for banking services be referred to the Competition Commission, but a referral should be actively considered if any of these conditions is not met by 2015.

Implementation

Policy decisions following our Report are for Government and Parliament to make. It would be good all round, not least for financial markets, if the Government could establish its policy by the end of this year, and if legislation could be passed well within the current Parliament.

A separate question is the timetable for implementation if the proposed reforms are adopted. The package of recommendations to promote financial stability consists of moderate elements but is fundamental and far-reaching. It could not all sensibly be implemented by 2015 even with legislation enacted next year.

The deadline for implementation of the internationally-agreed Basel III capital standards is the start of 2019. Our recommendations on capital, loss-absorbing debt and depositor preference go considerably further, but we see no case for extending that deadline. Neither would we require acceleration ahead of Basel. In any case, once policy is clear, market disciplines might operate sooner than regulatory timetables. Structural reform would inevitably take time following legislation and subsequent regulatory rule-making, but should be complete by the Basel date of

2019 at the latest, and preferably sooner. This may seem a long time. It is. But short-termism got us into this mess and we need long-termism to build a more stable system for the future.

On this basis the reforms that we recommend pose no significant risk to the economic recovery. The lesson from recent weakness, and the strains shown by banks, is just how important it is to reform the banking system. The 'too big to fail' problem must not be recast as a 'too delicate to reform' problem.

Ring-fencing will strengthen, not weaken, the framework for the supply of bank credit to households and businesses in the economy. Retail deposits will fund that flow of domestic credit, separate from global wholesale and investment banking. Higher capital standards, which can be achieved over seven years, represent just a few percentage points of bank balance sheets. The most rapid growth of those balance sheets has related to global wholesale and investment banking, and bank lending to other financial institutions. Credit supply to the domestic economy now accounts for a fraction of UK banks' balance sheets.

In many respects, then, our recommendations would restore UK banking closer to how it used to be – with better-capitalised, less leveraged banking more focused on the needs of savers and borrowers in the domestic economy. At the same time UK banks would be free to flourish in global markets, but without UK taxpayer support.

Our banks are at the heart of the financial system and hence of the market economy. The opportunity must be seized to establish a much more secure foundation for the UK banking system of the future.

END