The Law Society

Banking Reform: delivering stability and supporting a sustainable economy

September 2012

Banking Reform White Paper

Response by the Law Society

INTRODUCTION

1. The Law Society of England and Wales is the representative body of over 140,000 solicitors in England and Wales. The Society negotiates on behalf of the profession and makes representations to regulators and Government in both the domestic and European arena. This response has been prepared on behalf of the Law Society by members of our Banking Reform Working Group. The working group is comprised of senior and specialist lawyers with expertise in financial services regulation, banking, competition, EU and international commercial law and economists[1].

2. The Law Society welcomes the HM Treasury White Paper and this opportunity to offer our perspective.

3. The Law Society responds to this White Paper as a body whose 11,000 member firms are predominantly small or medium-sized businesses whose banking arrangements, funding and investment options would be directly affected by the proposals.

4. We also respond as a body whose member's have extensive experience in advising banks and other institutions on banking, finance and regulation, as well as businesses of all shapes and sizes and consumers. The working group represents some of the many members of the profession who advise in these areas and want to see effective and workable laws.

5. In addition, we are proud of the success of English law, with its high standards of legal certainty and reputation for fairness in dispute resolution. It is the international legal system of choice for many foreign businesses. The English and Welsh jurisdiction is a valuable economic asset, generating significant income for the UK. The final motivation for our response therefore, is to ensure that the UK maintains this competitive asset. It appears to us an unintended consequence of these proposals that risks arise in this area.

[1] See Annex II for full membership list.

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GENERAL COMMENTS

6. Before responding to the specific questions, we wish to make some general comments.

7. We welcome reforms that will increase the robustness of the banking system in an affordable and sustainable way and limit the cost of bank failure for the State. We do not question the decision to introduce ring-fencing of retail banks in pursuit of this aim. We do, however, have some questions in the light of the developments in the White Paper proposals whether the specific methodology for the proposed reforms set out in the White Paper could deliver this aim effectively in the global environment in which we operate in the modern world, while preserving international competitiveness for the UK's banking sector and/or avoid unintended consequences.

8. This is one of the most major structural reforms ever contemplated by the UK government to an industry so central to the economic health of the country. It is the task the implementation of which would carry inherent risks at the best of times and the care taken in testing every aspect of the proposals will be essential to its success. At the outset what will happen needs to be clear in legal terms, so that banks and their customers can plan and manage costs on a certain basis. It is, however, proposed to proceed immediately to legislation with some proposals in outline sketch, with no economic or practical study addressing customer needs and impacts (this is entirely missing from the Impact Assessment) and against a background of a continuing euro-zone crisis, a period of economic depression in the UK, the implementation of Basel requirements, and a host of EU and other UK legislative initiatives, most not yet settled, some of which may impact on this legislation and/or require changes to the resolution regime presently in place in the UK. This substantially increases the risk of a chaotic and uncertain period for the UK's banks and their customers, which will only divert from management of the banking businesses efficiently and with minimum cost through a period of stress and risks in itself diverting more than the necessary amount of effort from the primary task of providing robust banking services in a way that contributes to the recovery of the UK economy and the growth of UK businesses at home and abroad.

9. We strongly believe substantially more work is needed to reach a firm foundation for this reform and that without that work, there is a risk of serious unnecessary uncertainty and cost for banks and their customers and a heightened risk of adverse consequences to the economy. This work includes further cost analysis and economic modelling of the effects on consumers and business customers, especially those which are likely to have their sole banking relationship with a ring-fenced bank. If our remarks seem critical, they reflect very real concerns.

10. We have made a number of suggestions, which we hope will be helpful and constructive, and assist in achieving greater clarity and a firmer basis. We are concerned that the Government should achieve the best outcome for the UK economy as a whole, for consumers and for business customers.

The international context

11. The UK and its economy cannot be insulated from the world in which we live and, in particular, from the European Union of which we form a part. Nor can we be insulated from the economies of other nations outside the EEA. Our leading UK businesses, including banks, and a significant number of legal firms, members of the Law Society, operate in many jurisdictions worldwide.

12. We therefore have to consider UK proposals in the light (particularly) of the impact of EU proposals for reform in the same area, and the extent of the reforms being carried out by other economies, particularly the USA, and the baseline international obligations under the Basel accords that are binding on a wider range of countries. The proposed reforms are long term and structural with on-going and cumulative effects on the economy every year. Systemic bank failure is an event that is historically relatively infrequent and may have originated in different areas, even if with a similar cause each time it occurs. [2] It is therefore important to proceed with caution.

13. If we move too far away from the general pattern of international reform we risk the competitiveness of the United Kingdom, could drive away business, encourage UK business to invest abroad and not at home and could degrade the ability of our emerging businesses to grow (through cost and/or lack of funding), as well as raising costs for consumers, limiting employment opportunities and creating a long term stagnant economy. How far these reforms carry the risk of doing this depends not only on their content, but on the environment in which they are implemented.

14. If other nations entitled to do business in the UK under our EU and WTO obligations do not embrace similar reforms, then the adverse impacts will be greater and the benefits gained could be far outweighed by these adverse effects. In proceeding with reform at a time when EU measures are still in debate and when other EU countries, including leading economies such as Germany and France, do not appear to favour banking separation as a reaction to the crisis, the UK may be taking a considerable risk. The fact that important details that will affect the cost of the proposals are not fully thought through and that unintended effects on international relationships and other areas of business have not been fully analysed, increases our concerns.

15. We summarise our major concerns and suggestions to address them below:

The economic and international impact has not been fully thought through

16. We have a high level of concern that the proposals remain insufficiently thought through and detailed for the implications to be assessed and any estimates of cost or economic impact to be reliable. This undermines the value of the current economic impact assessment and we think it likely that it does not fully recognise the costs (which will be constant, long term and structural) for the UK's competitiveness and the wider economy. The reforms focus on the outcome of saving public money in the event of the further occurrence of significant bank failure, which is of course absolutely right, but which has to be put in the context of the frequency of bank failure, so that the cost of the remedy is not disproportionate to the risk. We do not believe that the impact assessment has fully taken that on board. It also has no consideration at all of the impact on customers, either as individuals or businesses, of the proposed restrictions.

17. We urge that further economic impact assessment is carried out before legislation is introduced, including:

    - Looking from the point of view of individual consumers and small businesses at the impact on cost and availability of funding and services, including studies of the effects on smaller exporting businesses (see our observations at 3 below).[3] We believe that this is an essential duty to the public and to business, including Law

[2] For example the 1929 crash related to an equity bubble, but the 2008 problems were to a large extent triggered by the property market in the USA and the securities issued on the back of a bubble in that market.
[3] These studies would need to be done with the benefit of the further work we discuss in the following bullet points of this section, but we place the need for customer specific work first, because it is of vital importance to ensure that the measures taken are viable and free of unintended adverse consequences.

Society members, who will be directly affected by limitations imposed on ring-fenced banks. There is already concern being raised that regulatory policy and an economic policy that requires economic growth are at odds and that the regulatory moves already made are inhibiting bank lending and stifling growth. These proposals, as presently formulated, go further down the same regulatory road as the reforms already being implemented and seem to deliver inevitable increases in cost and reduction of the availability of capital for customers of ring-fenced banks, whether individuals or businesses. This particularly seems to affect activity abroad, whether trading or personal, because ring-fenced banks will be looking inward without any presence outside the EEA and will face restrictions on how they can deal with banks outside the ring-fence anywhere in the world.

- Considering and costing properly detailed proposals to restrict the activities of ring-fenced and non-ring fenced UK regulated banks. It is not in our view sufficient to try to cost in a general way: the specifics of the reforms will each have a measurable effect. For example, if ring fenced banks cannot deal with insurance companies (or only to a limited extent) this will reduce the services they can offer consumers and business customers and there is no analysis of the consequent risks, costs or effects on competition that would arise. There are a wide range of proposals of this sort canvassed in the White Paper in general terms and not as a complete list, but each needs to be clarified, and analysed in detail before any reliable costings can be achieved.
- Costing various different international environment scenarios, including ones where unitary banks regulated elsewhere in the EEA (whether EEA or third country in origin) are entitled to offer services to UK customers, and the impact on the competitiveness of UK regulated banks and its feed through to the wider economy.

Unnecessary Protectionist Aspects

18. In addition there are aspects of the proposals that are protectionist in a way that is at odds with the ethos of a free market economy and that are of a nature to encourage protectionist acts by other countries, including the UK's major non-EU trading partners. The justification for these is not currently made out.

19. One of the examples with potentially serious unintended consequences impacting on the legal profession, is the proposal that ring-fenced banks should only be able to contract major obligations under EEA laws, excluding their ability to contract under highly respected legal systems such as those of New York and Switzerland, but leaving them free, to take an extreme example, to contract under the law of (say) Romania, with dispute resolution in (say) Somalia (the question of jurisdiction for dispute resolution is legally separate from that of governing law). It offers an insult to major trading partners, likely to damage not only the competitiveness and access to markets of UK regulated banks, but the place of English law as the legal system of choice in much of the world and the income which that generates for the UK; this is because this type of measure invites retaliation on a wider scale which might prevent or reduce the current widespread use of English law. The legal profession would bear the brunt of that decline, but the whole of the UK would be poorer and there would be an impact over time on the UK's standing overseas.

20. It is also based on a misapprehension that use of a non-EEA legal system exposes banks to unacceptable risks. This is plainly not the case: major financial transactions are very rarely written under the laws of any jurisdiction that is not widely respected and also contains a major financial centre. Further, choice of jurisdiction for dispute resolution is at least as important, probably more so, than choice of law and the most popular jurisdictions (England, New York and Switzerland are the top 3 – often used for contracts

governed by another law) are all highly respectable. Nothing would be gained by cutting off any UK business, including ring-fenced banks, from choosing to contract and arrange dispute resolution under these laws and a good deal of damage would be done: the proposal does not reflect the general principles of comity in international law in relation to the recognition of laws that do not offend against national mandatory rules or public policy (which are of general application), and, in particular, has scant regard for the many legal systems modelled on our own and the long-standing mutual respect particularly afforded to the laws of such countries, (e.g. the UK has many Treaties on mutual recognition of judgments with members of the Commonwealth outside the EEA). No full appraisal seems to have been undertaken as to whether this proposal would be consistent with the UK's international obligations, or as to the economic and political consequences of it.

21. Finally, if the intention is to address a concern that foreign legal systems will not recognise resolution steps, this can be better dealt with by providing that such contracts must contain contractual rights to assign (at least in resolution circumstances) and an obligation on the contracting party to recognise the effect of transfer orders under the Banking Act 2009 (and successor legislation).

22. We suggest that this proposal should be abandoned.

Implications for consumers and SMEs and the effects of these implications on the wider economy

23. As proposed, most consumers or SMEs will effectively be forced to place their deposits with ring-fenced banks, with the other obvious alternative being non-UK banks regulated in other EEA Member States. These banks are and will continue to be able to exercise their passport rights to provide retail banking services to customers in the UK (either from abroad or through UK branches) regardless of structure.

24. Under the proposals customers of UK regulated banks seem to risk suffering a very considerable diminution in the services their UK regulated banks can offer them, ranging from foreign exchange and overseas banking management to levels of return, the exact extent of which is currently unclear because of the wide range of restrictions being canvassed. Indeed, the proposed reforms seem calculated to place ring-fenced banks perpetually in a situation where their cost of capital will be higher than for other banks, and their ability to make their capital work hard will be constrained, so that their customers could be expected to bear higher costs than the customers of other banks and potentially suffer poorer service, including less availability of loans, as ring fenced banks seek to constrain their costs.

25. Where there is flexibility, the rational customer will move its banking relationship elsewhere. Where there is not, the customer will suffer, and current complaints about lack of loan capital for SME start up and expansion seem set to rise without long term public subsidy of bank lending to SMEs (something not envisaged or taken into account in the impact assessment). Two points emerge:

    - Economic case studies are essential to demonstrate the potential impact on consumers, on jobs, on the potential for economic growth and on UK competitiveness.
    - The level of flexibility afforded to ring-fenced banks to meet customer needs has to be informed by these studies. It seems to us that there needs to be flexibility in the range of services well-resourced ring-fenced banks can offer if there is not be

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additional loss of welfare for growing businesses and for individuals, or a cycle of loss of business by UK regulated banks to banks not constrained by the ring fence.

26. There is no discussion of the loss of business by UK regulated banks as a result of banks regulated in other EEA Member States using their passport rights to meet demand, but this needs to be carefully considered in the context of the impact assessment, bearing in mind the very real current doubt that other EEA countries will adopt ring fenced schemes. Banks that may be able to take advantage of the passport in this way are not just EEA headquartered banks, but banks headquartered in third countries with subsidiaries established and regulated in the EEA.

27. As indicated above, it seems likely that the ring-fenced UK regulated banks would be considerably more expensive than EEA or third country bank subsidiaries regulated in the EEA providing equivalent pass-ported services in the UK. As a result, UK business customers seem likely to avail themselves of those banks, but, in the event of a future crisis, they may repatriate or sweep the UK business customers' cash to the home jurisdiction. The ring-fence proposals could not prevent this. If the effect on competitiveness is as significant as we suspect, the systemic risk presented by the probable flight of capital in this scenario may be higher than the systemic risk of individual or even multiple UK regulated bank failures. This also needs to be built into a further impact assessment, conducted in a contextual way rather than on the assumption that UK consumers and businesses only have access to UK regulated banks. It is one of many strands that need to be costed and thought through fully.

28. We note that larger UK building societies are likely to be regulated in a similar manner to ring-fenced banks (see separate consultation paper), which will limit further their opportunity to be a countervailing competitive force within the UK. This also need to be factored into the impact assessment, although the struggles of that sector's business model in a low interest rate environment have already limited its ability to impact positively in the market place in the current climate.

29. The other parties likely to fill the gap are smaller firms of financial intermediaries for individuals and various types of 'shadow-banking' for small corporates. As regards financial intermediaries, the risks are obvious: individuals being forced to deal with smaller intermediaries, rather than their bank, for relatively simple non-deposit investment products, for share trading and for access to some more sophisticated financial products will be at greater risk than if dealing with their bank. These intermediaries are less able to withstand financial shocks and it is more likely that instances both of mis-selling and failure without compensation will occur. This impact, which could be expected to reduce the benefits of restricting the activities of ring-fenced banks, has not been assessed, but this should be done, on a range of assumptions, including a "worst case" scenario.

30. We note the rise in various forms of 'shadow banking' which seek to exploit a lack of funds from traditional banking sources. These businesses operate outside of the banking regulatory regime, but EU moves could bring them within it or within a parallel regime with many similar features (See the *European Commission Green Paper on Shadow Banking* (COM(2012) 102 final) of 19th March 2012. They cannot therefore necessarily form an alternative. In any event with the growth of the sector, greater regulation would be inevitable to contain risk. We note, however, that neither the impact of currently available forms of 'shadow banking' nor of greater regulation of that sector are considered. This is another gap in the impact analysis.

31. Finally the Treasury is conducting parallel consultations on Broadening the Financial Sector Resolution Regime and Setting the Strategy for UK Payments, as well as on the

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Future of Building Societies, the FSA is in the midst of an on-going exercise affecting the FCSC Compensation Scheme and its funding, and the European Commission has a number of ongoing initiatives, including on Cross-Border Resolution and that on Shadow-Banking referred to above. The resolution of the Euro-zone crisis may also affect the regulatory regime for Euro-zone banks. Each of these has the capacity to affect the effectiveness and practicality of the proposals under discussion in a variety of different ways. All these are in addition to the implementation of the Basel proposals on capital adequacy, which are still in progress, and the UK and EU banking regulatory reforms already legislated for. With so many aspects of banking regulation and operations subject to change, it seems to us vitally important that thought is given to the best order to address the various reforms and the assessment of inter-related effects, especially where the shape of so many of these reforms is unclear. Without some sort of overall plan and a sophisticated model to assess and reassess interacting impacts, as well as the right to hold back reforms in the light of other developments, the risk of unintended consequences is very high, as is the risk of creating unnecessary uncertainty and cost and diverting resource from the business of providing banking services in a way that assists the recovery of the economy and the growth of business.

Competition

32. Our concern is that the proposals as presently formulated will make the banking services available to UK consumers and SMEs expensive and limited, with most retail banking operating to a very similar model with a very similar cost base and little room for product innovation. The dynamic effects of the proposals as they stand are likely to be multiple, including:

    - This is bound to increase barriers to entry and expansion, and the ability of smaller institutions to challenge established UK banks,
    - Creating a more cautious market, leading to difficulties in fund raising by smaller entities,
    - Creating incentives to consolidate to recover lost group economies of scale and to improve the ability to save costs,
    - Causing ring-fenced banks to have very similar business profiles and cost bases,
    - Encouraging attempts to use alternative avenues to access the market, with new business models that might be more systematically dangerous and offer less protections for consumers because they are lightly regulated and have no compensation scheme in the event of failure,

33. The competition section in the White Paper emphasises regulatory intervention to ensure switching is more prevalent and that competition is a key objective, but, as discussed later in this paper, the impacts above carry the very real risk that they will have the opposite effect and tend to deter vigorous competition for customers and switching between ring-fenced banks, reduce customer choice, discourage market entry, encourage branch closure, stifle innovation within retail banking and raise prices to the customers of ring-fenced banks.

General conclusion

34. We consider that the full range of risks which the proposed system of ring-fencing might create needs to be properly evaluated, including a thorough analysis of the impact on consumers and SMEs, including on a “worst case” scenario. If "protectionist" measures are taken forward their impacts, both in terms of retaliatory measures and possible infringements of EU law need to be taken into account. The White Paper and the consultation do not appear to have taken these risks fully into account. As the impact is

likely to be highly sensitive to variables, particularly the exact restrictions placed on ring-fenced and non-ring-fenced banks in their acceptance of customers, these need to be fully developed and evaluated: the paper does not contain fully worked out proposals and the impact assessment does not have the material needed to do this work and does not seem to overly recognise that this undermines the assessment of cost.

35. In particular, there is a need to model the effects of the proposed restrictions on consumers of banking services, especially SMEs involved in international trade or service provision.

36. We suggest that a great deal of further detailed evaluation and re-assessment is needed before a White Paper standard of assessment can be reached. This should be addressed as a matter of urgency, to ensure that reforms are brought forward on a sound basis and do not cause unexpected harm.

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QUESTIONS

Consultation Question 1

- **What are your views on the appropriate threshold above which firms should not be required to place their deposits in a ring-fenced bank?**
- **Do you believe that firms below this level should have the opportunity to opt out of this requirement if they meet certain criteria? If so, what should those criteria be?**
- **What are your views on the appropriate threshold above which individuals may Opt-out of placing deposits in a ring-fenced bank? How should it be measured and at what level should it be set?**
- **What are your views on the Government's proposals for dealing with instances where SMEs or individuals cross those thresholds? Should this be set as an assessment over a sustained period? What should this period be?**

General Observations

37. Before responding to the specific questions, we wish to make some general comments about the way in which the population of customers whose deposits are required to be held by a ring-fenced bank (or outside the scope of the UK regulated system) is to be defined. The consultation document proposes the application of separate definitions of small and medium-sized enterprises (*SME*) and high net worth individuals (*HNWI*) to determine this population of customers. In practice, this would involve the introduction of an additional set of customer definitions to the client on-boarding process, which will inevitably increase its overall complexity and the associated cost.

38. In light of this, we think that a better approach would be to utilise existing customer definitions to define the population of customers whose deposits are required to be held by a ring-fenced bank. In particular, we think that there is considerable merit in invoking the definition of a retail client applied under FSA rules to define this population of customers. This definition is derived from the *Markets in Financial Instruments Directive* (*MiFID*) and includes any client who is not a professional client or an eligible counterparty. It has the significant advantage of being a definition which regulated firms have applied since 1 November 2007 and in relation to which they should already have effective customer on-boarding procedures and processes. Adopting our suggestion would mean that any customer who was categorised as a professional client or an eligible counterparty under FSA rules would have the option to deal with non-ring-fenced UK regulated banks. It would also allow UK regulated banks to utilise existing customer on-boarding procedures and processes when determining which of its customers should have their deposits held by a ring-fenced bank.

39. The current concepts of a professional client and an eligible counterparty are articulated in Rules 3.5 and 3.6 of the FSA's Conduct of Business Sourcebook (*COBS*) and include, in each case, distinct sub-categories of automatic (*per se*) and opted-up (elective) clients. We would submit that customers falling into both sub-categories of professional client and eligible counterparty should be free to place their deposits with non-ring fenced banks and that this freedom should not be restricted to customers falling into the *per se* sub-categories.

40. Rules 3.5 and 3.6 of COBS also draw a distinction between regulated business falling within the scope of MiFID and regulated business falling outside the scope of MiFID (*non-MiFID business*). As regulated business involving the acceptance of deposits falls

outside the scope of MiFID, we think it would be appropriate (and would strike the right balance) to apply the professional client and eligible counterparty definitions for non-MiFID business in order to define the population of customers who would have the option of having their deposits held by non-ring-fenced UK regulated banks.

41. We note that HM Treasury is receptive to the introduction of processes similar to those applied under MiFID (notably in relation to the treatment of individuals as HNWI) and would urge it to adopt MiFID derived client definitions more broadly when defining this population of customers.

Mandating activities to Ring-Fenced Banks

42. Another note before addressing these questions: they are framed as if the customer's only option is to place deposits with UK regulated banks and reflect an apparent intention to mandate deposit taking activities in the UK to ring-fenced banks only. We doubt very much that this approach is lawful under EU law. EEA passported banks, regardless of structure, are free to trade in the UK (whether on a cross-border basis or through the establishment of one or more branches in the UK) and only either EU law or their national regulator could enforce that they do so with a ring-fence structure or limit their customer base.

43. In addition, rules on the free movement of capital and service and the right of establishment, mean that it would be a breach of the UK's treaty obligations to seek to prevent UK nationals or residents or UK SMEs or UK branches of foreign registered SMEs (whether from within or outside the EEA) from dealing with these banks, since it would effectively negate their right of establishment under their own lead regulator to provide the full range of banking services. It would also involve interference with the group banking arrangements of overseas groups who are investors into the UK. This is not calculated to encourage inward investment and the jobs that this produces.

44. What the UK can do is prevent UK regulated non-ring-fenced banks from accepting deposits from UK nationals ordinarily resident in the UK and from UK registered SMEs (or indeed otherwise providing banking services to them). Clearly if a UK national is working outside the EEA (or in an EEA State where his ring-fenced bank does not have a branch) it would be wrong to force him or her to bank with a non-UK controlled bank. The branch or subsidiary of an international banking group headquartered in the UK which offers personal banking services in e.g. the United States, will necessarily, as the proposals are framed, be outside the ring-fence and it will depend on structure whether it is subject to UK regulation.

45. We think therefore that both the legislative proposal and the questions are therefore incorrectly framed: firms and individuals will remain free to place deposits where they wish in the UK and elsewhere (assuming exchange control is not revived for countries outside the EEA), but non-ring-fenced UK regulated banks (and the parts of large UK regulated banking groups outside the ring-fence) will be obliged to reject deposits from most individuals and SMEs (which are the vast majority of UK bank customers).

46. We have not sought to correct each question individually, but have alluded to this fact where appropriate.

What are your views on the appropriate threshold above which firms should not be required to place their deposits in a ring-fenced bank?

47. As discussed above, we think that the most appropriate yardstick would be to require deposits from customers who are categorised as retail clients under FSA rules applicable

to non-MiFID business to be rejected by non-ring-fenced UK regulated banks. The threshold above which firms should not be required to place customer deposits in a ring-fenced bank would therefore be set at the level of customers who could be validly categorised as professional clients or eligible counterparties (i.e. not as retail clients) under FSA rules applicable to non-MiFID business.

Do you believe that firms below this level should have the opportunity to opt out of this requirement if they meet certain criteria? If so, what should those criteria be?

48. We support the principle of customer choice and feel it would be inappropriate for genuinely informed and/or sophisticated customers to be forced to hold their deposits with a ring-fenced bank simply because they failed to meet quantitative criteria applied under an SME or HNWI definition. In this regard, we think that our suggestion of preventing deposits received from customers who are categorised as retail clients (as defined under FSA rules) from being held by non-ring-fenced UK related banks would go a significant way towards addressing this concern, provided the less restrictive client definitions applicable to non-MiFID business are applied in practice.

What are your views on the appropriate threshold above which individuals may opt out of placing deposits in a ring-fenced bank? How should it be measured and at what level should it be set?

49. Please see our response to the previous question.

50. We do not agree with the Government's view that the threshold for a HNWI exemption should be based on the free and investable assets held with a single bank. As the Government recognises, looking at assets held by an individual with a single bank may fail to provide a complete reflection of an individual's wealth. We would submit that this risk is heightened in the case of HNWI who are far more likely to spread their asset portfolios across several financial institutions, a pattern that may recently have been influenced by applicable investor compensation scheme limits.

51. FSA regulated firms have considerable practical experience of applying client categorisation tests based on the totality of a client's assets and of making judgments about whether a given test has been satisfied. Of particular relevance is the professional client definition applied under FSA rules which uses total asset formulations in both the *per se* and elective client sub-categories.

52. We consider that the risks of allowing non-ring-fenced banks to accept deposits from individuals on the basis of their total assets (which there are already procedures for assessing) are very much less than the potential downsides of forcing UK regulated non-ring-fenced banks to reject deposits from genuinely wealthy individuals who wish to spread their assets across several financial institutions on the grounds that the deposits and other assets to held with the particular UK regulated bank are not valuable enough. This would tend to encourage high net worth individuals to use non-UK-regulated banks and place UK regulated non-ring-fenced banks at a competitive disadvantage.

53. Our suggestion that deposits received from customers who are categorised as retail clients (as defined under FSA rules applicable to non-MiFID business) could not be held by non-ring-fenced UK regulated banks would involve the application of total asset formulations when determining whether a customer should be so categorised.

What are your views on the Government's proposals for dealing with instances where SMEs or individuals cross those thresholds? Should this be set as an assessment over a sustained period? What should this period be?

54. We believe that these concerns would be alleviated if the Government adopted our suggested approach, so that deposits that are received from customers who are categorised as retail clients (as defined under FSA rules applicable to non-MiFID business) could not be held by non-ring-fenced UK regulated banks. Existing client categorisation processes and procedures adopted by FSA regulated firms in response to the implementation of MiFID should already address situations in which customers previously treated as professional clients or eligible counterparties no longer meet the criteria to be so categorised. Leveraging off these processes and procedures would clearly take advantage of an existing body of industry practice but would not address the detailed practicalities of how the transition of deposits would be managed.

55. In this regard, we think it would make sense to look to industry guidance to address the practicalities of how a non-ring-fenced UK regulated bank would transition a customer's deposits to a ring-fenced bank where the customer no longer met the criteria to maintain deposits with a non-ring-fenced UK regulated bank. We note that industry guidance was successfully developed by the British Bankers' Association to address the introduction of the FSA's Banking Conduct of Business Sourcebook (BCOBS) and the potential relevance of BCOBS 5.1 and Principle 6 of the FSA's Principles for Businesses to this issue.

Consultation Question 2

- **What are your views on the proposed restrictions on ring-fenced banks' activities outside the EEA?**
- **Should any further restrictions be applied to the scope of ring-fenced banks' activities to ensure that the objectives should be met?**
- **What are your views on the costs and benefits of such restrictions?**

What are your views on the proposed restrictions on ring-fenced banks' activities outside the EEA?

56. This question appears to focus on the geographical restrictions section of the proposals and we shall therefore deal with the restriction of activities in response to the second element of the question.

57. We comment on each of the proposed restrictions in turn:

    A restriction on ring-fenced banks carrying out any banking activities through non-EEA subsidiaries or branches:

58. While clearly the UK cannot under EU law prevent establishment of branches in other EEA Member States on grounds related to the country of establishment, we question whether it is necessary to actually prevent the establishment of branches elsewhere, as these will to a considerable extent remain under UK supervision. It would surely be sufficient to provide that the regulator should approve the establishment of a branch outside the EEA and its scope of activities.

59. As regards subsidiaries, there is a suggestion elsewhere that a ring-fenced bank should not have subsidiaries, in which case a provision dealing with place of establishment

would be unnecessary. However, we believe it is impractical to provide that a ring-fenced-bank should not have subsidiaries. A subsidiary established abroad would be regulated in the place of establishment, but we believe it would be sufficient to legislate that the UK regulator would need to approve the establishment, the level of capitalisation, the activities and the governance of any such subsidiary. A principle that the activities should be incidental to the business of the bank as an EEA retail deposit taker would also be a useful safeguard. We do not, however, consider that total prohibitions would be appropriate or proportionate and again, the proposals pay little regard to strong traditional relations between the UK and a number of important non-EEA jurisdictions. While we note that there are discussions with the Channel Island jurisdictions and the Isle of Man, other non-EEA jurisdictions of equal or greater importance to British business and British banks are not yet being consulted, and we doubt that they would react well if they were made aware of these proposals, which suggest they would not be regarded as competent regulators. In their present form these proposals appear to be an unnecessary invitation to these well-respected countries to adopt protectionist measures against the UK, which may in turn damage the City of London as an international financial centre.

All major service and credit contracts must be written under the law of an EEA Member State:

60. This suggestion, is, we fear, sadly misconceived and is fraught with unintended consequences. It fails to reflect the UK's obligations to respect the law and jurisdiction of a wide range of non-EU countries with whom the UK has entered into Treaties on the mutual enforcement of judgments. It also ignores the general approach of international law to comity between nations, an area of international law in whose development the UK has played a leading part. It smacks of protectionism[i] in a manner that is damaging to the reputation of the UK internationally and invites retaliation that would be deeply damaging to legal relations, to the ability of UK businesses to trade outside the EEA, and to the use of English law in international dispute resolution. It may also have commercial impacts on the ability of ring-fenced banks to serve their customers and get best value for money in their procurement. We do not believe it is necessary to address concerns about the enforceability of foreign law contracts if a transfer order is made in a Banking Act 2009 resolution, which may be the purpose of the suggestion, although it is not entirely clear this is the case.

61. Given the potential wider negative impacts of this aspect of the proposals (which extend across a range of areas outside banking) we strongly urge the Government to abandon this proposal and consider an alternative way of addressing concerns about recognition of resolution orders, as suggested below.

Choice of law and enforcement and international obligations

62. There are various elements that go to the creation of a contract, including its governing law and the method and place of dispute resolution. Most legal systems worldwide broadly conform to the principles of the legal systems of the UK jurisdictions (England and Wales, Scotland and Northern Ireland) and court and arbitral decisions applying a wide range of foreign laws are regularly enforced in the UK. Under the EU Rome 1 Regulation, there are comprehensive rules for the recognition of application to contractual obligations of the law of any country worldwide within the UK (not just the application of EEA laws) and the UK is bound to respect that rule. To the extent that enforcement would offend against mandatory or public policy rules within the UK, the Rome 1 Regulation provides that that can be taken into account. No advantage would be gained by limiting the range of laws which ring-fenced banks can choose for their

contractual obligations, while, in the absence of express choice, the application of the Regulation may lead to the application of the law of a non-EEA State in any event, and it would be a breach of the UK's Community obligations to seek to exclude or limit that effect .

63. It is also unlikely that any third country would recognise the proposed rule where there was an express choice of the law of that country in breach of the proposed rule or as a result of application of private international law rules in the absence of choice, but judicial authorities and governments in third countries would regard the rule as lacking in comity and not consistent with public international law principles as between friendly states.

64. In practice the governing law of a contract is rarely an obstacle to fair and effective enforcement. Given the proposed limitations on place of business, a ring-fenced bank is likely to have most of its assets within the UK and therefore enforcement against it will have the protection of the courts within the UK. The provision is therefore likely to cause far more damage (as a result of retaliatory measures causing wider harm to the UK business and professions) than good. To give examples:

- It would allow a ring-fenced bank to contract under the law of (say) Romania with exclusive jurisdiction for dispute resolution given to the courts of (say) Syria, but would not allow a ring-fenced bank to contract under the law of New York, Switzerland, Australia, Jersey, the Isle of Man or a wide range of other highly respected jurisdictions, even if dispute resolution would be exclusively in London.
- It would throw doubt on the ability of a bank to provide or participate in letter of credit facilities for its customers, since these valuable instruments for international trade, including with developing countries, are written under the International Chamber of Commerce *Uniform Customs and Practice for Documentary Credits* (currently UCP 600) usually without any express choice of law. Relations with correspondent banks in the customer's or supplier's country, which are an essential part of the arrangement, on analysis under normal rules for identifying governing law, are unlikely to be governed by the law of any part of the United Kingdom; the system would not work effectively if this were insisted upon. Because of the well-understood basis and case law on the UCP internationally this is not a practical problem, but an inability for a ring-fenced bank to contract under a foreign law would deprive its UK customers of an essential service.

65. The method and place of dispute resolution is in practice far more important to fair and reasonable determination of disputes about the meaning or application of contractual obligations. Again the UK is party to Treaties on the enforcement of arbitral awards and is bound by the Brussels 1 Regulation on recognition of judgments (presently applicable only to EEA States, but with proposals to apply to third countries under consideration). In addition it has a wide range of other Treaty obligations to recognise the judgments of a range of other jurisdictions (particularly with a considerable number of Commonwealth countries). We would not suggest that any measure should be taken which would in any way derogate from those international obligations or place ring-fenced banks at a disadvantage in their contractual dealings.

66. In addition an apparently protectionist approach invites retaliation, limiting the use of English law outside the United Kingdom by banks or more widely. This would affect the attractiveness of these laws in international banking and commercial agreements (where English law is probably the leading choice worldwide) and encourage the use of other laws and other international centres for both business activities and dispute resolution. This would be a spectacular "own goal" against our economy and its effects would, among others, fall particularly heavily on the UK legal professions both in the UK and in their businesses abroad.

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Risk of commercial consequences for ring-fenced banks and of adverse effects in resolution

67. The rule could have damaging commercial consequences, such as:

    - Preventing supplements to existing contracts e.g. for IT governed by foreign law, which could make, for example, updating IT systems problematic;
    - Cutting off banks from the best technical solutions or best price if these came from suppliers who insisted on their own law;
    - Coupled with the restrictions on dealing with non-ring-fenced banks and operating outside the EEA, possibly cause difficulty in, for example, accessing US dollars to meet the needs of customers who deal in products priced in that currency (e.g. oil and gas, grain etc.): a study is needed to see if this could be a real risk and how it might be addressed.

68. The proposal is unclear what would be the consequence of breach of the prohibition. Under general principles, a restriction on choice of law could be viewed as a restriction on capacity of the bank to contract under that law (at least for contracts above a certain value), in which case a foreign law contract in breach of the prohibition would be void. Rather than assist the enforceability of resolution transfer orders, this would give counterparties the right to walk away, which could cause losses to the bank and its creditors in resolution.

Proposal to address concerns that foreign laws may not recognise the effect of transfer orders in resolution

69. The White Paper hints that the concern is that a foreign law might not recognise a transfer order in resolution lies behind the proposal. However, that could be better addressed by requiring a ring-fenced bank to get contractual recognition of such a transfer in all major contracts, regardless of governing law.. This would be supported by a checking and audit process within regulatory rules. There would seem to be no objection under EEA law to that being a general requirement for all contracts of a ring fenced bank, which would also cover the fact that, as the law stands at present, this may well be a problem within the EEA as well as without, although it is possible that there will be changes in EU law relating to bank resolution which would explicitly recognise resolution processes of the sort introduced by the Banking Act.

70. If that is not the concern being addressed, a general regulatory direction to be satisfied on the appropriateness and likelihood of fair dispute resolution in respect of major contractual obligations of ring-fenced banks is the most that could be needed consistently with the UK's international obligations. As the board of a company acting in its interests would have to have regard to those matters in any event, we doubt that even that is needed.

Should any further restrictions be applied to the scope of ring-fenced banks' activities to ensure that the objectives should be met?

71. As noted above we consider the proposed restriction on choice of law should be abandoned.

72. With regard to the prohibition on carrying out certain activities, if enshrined in primary legislation, there will be unintended consequences, unless there is an ability to make exceptions by way of statutory instrument.

73. For example an inability to trade in shares as a principal would restrict ring-fenced banks from carrying out any activity that incidentally involved dealing with shares: e.g. lending on the security of shares where the exercise of appropriate enforcement rights would result in a bank selling shares as a principal.

74. Another potential area affecting banks themselves, would be their ability to carry on with existing and new joint venture arrangements, which necessarily may involve dealing in shares (e.g. on a change of ownership of a stake, pre-emption provisions would be normal). While the ability of ring-fenced banks to carry on such activities may be limited by other aspects of the proposals, we are of the view that blanket prohibitions on share-dealing as principal are not the correct approach. Carrying on a business as a book-maker or trader in shares for the bank's own account may perhaps be appropriate for prohibition, but this needs narrow definition, which does not prevent normal business activities which necessarily require some dealing in shares as principal. The concern there should only be to have an appropriate regulatory regime.

75. Any provisions enshrined in primary legislation will have a profound effect on the financial viability and competitiveness of ring-fenced banks. A White Paper should spell out precisely what is proposed and the rationale behind the proposals. As this paper does not do this we consider that it is essential that the detailed proposals in this regard are set out and the subject of further consultation in advance of legislation and that it is only at that stage that meaningful comments on possible omissions can be made.

76. We also wish to express concern at the general principle enunciated that ring-fenced banks "should be largely prevented from carrying on international …banking services. The general thrust of the ring-fence is to, as far as possible, limit SMEs, as well as individuals, to dealing with ring-fenced banks. All customers need some international services (foreign currency, right to use debit and credit cards abroad, direct transfers to creditors or family members abroad using SWIFT transmission services etc) and we do not think it is intended to prevent this, although this is not specifically stated. In particular, there is nothing to explain how a ring-fenced bank will maintain relations with e.g. a US dollar clearing bank, when it cannot deal with non-ring-fenced banks whether in its own group or elsewhere, cannot contract under a non-EEA law and is severely limited in debt exposures to such bodies. However, SMEs usually only have one banking relationship and if they are exporting businesses or internet based service businesses, they need that bank to have an international outlook, to be able to deal with payments to and from jurisdictions within and without the EEA and, where appropriate, to support expansion outside the UK, again whether within or without the EEA. Yet these banks will be forced to close any branches outside the EEA or transfer them to a part of their group they can only have limited dealings with. What assurance can SMEs have that barriers to trade and to growth will not be substantially raised by this approach?

What are your views on the costs and benefits of such restrictions?

77. Without more detailed information, the costs and benefits are inevitably uncertain. As noted above, we consider the costs of "protectionist" measures to the UK economy are likely to be considerable, affecting not only the banking industry but the legal profession and other professions[4]. We do not believe that the economic impact assessment recognises these costs, while in other respects greatly more detail would be needed for a meaningful economic impact assessment. As things stand, we can only say that our general impression is that the negative impacts (which are perpetual, regardless of the solvency of affected institutions) seem likely far to outweigh any savings in the event of a

[4] It is likely that the ultimate effect will be an increase in the cost of money. This will have an adverse effect upon corporate finance activity generally which will affect accountancy and related professions in addition to the legal profession, and in addition to the businesses of suppliers and others.

further banking failure and that no attempt has been made to work out how the proposals would actually impact individuals and SMEs. We suggest at the outset the steps that we believe should be taken to address these issues.

78. To some extent, concerns may arise from the way that the consultation proposes prohibitions, concentrating on legal form rather than purpose. While obviously a simple business is easier to resolve should it fail, the UK needs banking businesses that are responsive to the needs of their customers both at home and in international trade and travel. If customers find that ring-fenced banks cannot offer what is needed, they will be driven to non-UK regulated banks or to more risky solutions or will simply be left at a disadvantage in their business endeavours and personal arrangements.

79. We would suggest that a proper identification of customer needs and how they can be met must inform any limitations of activities. We also believe that there should be more concern to ensure that assets of a ring-fenced bank are held securely rather than to focus on what a ring-fenced bank cannot do.

Consultation Question 3

- **What are your views on the restrictions on ring-fenced banks' exposures to financial institutions as proposed?**
- **What are your views on the types of exposure that should be permitted or prohibited?**
- **What are your views on the types of institution that should be classified as financial for these purposes?**
- **What are your views on how these restrictions should operate in practice?**

80. We are concerned that rules (albeit subject to exceptions) preventing ring-fenced banks from taking on exposures to certain classes of financial institutions would be overly restrictive and even counterproductive.

81. First, blanket bans on exposures to generally defined categories of counterparties, affecting all ring-fenced banks, would naturally focus considerable attention on the specifics of what was prohibited and what was permitted in terms of counterparty exposures and thereby incentivise a narrow 'compliance culture'. Ring-fenced banks' risk and compliance teams would be directed to be concerned with whether or not a particular potential counterparty exposure was on the blacklist of exposures, rather than considering whether, on an analysis of both the ring-fenced bank's and counterparty's individual circumstances, needs, and other financial/economic circumstances, it was prudent and appropriate or not to enter into transactions with such counterparty. This would both restrict ring-fenced banks from entering into otherwise financially prudent transactions with certain financial institutions, whilst encouraging ring-fenced banks to enter into imprudent transactions with other financial institutions, simply on the basis of whether or not exposures to those financial institutions had been included on the blacklist.

82. Secondly, if there is to be a ban on exposures to certain counterparties, it makes little sense to apply blanket bans to all ring-fenced banks in respect of all counterparties that happen to undertake certain activities. There may be a case for regulatory powers to prohibit or limit certain types of exposure, but the crude measure of blanket bans affecting all ring-fenced banks and building societies has the potential to limit competition severely and restrict the ability of these institutions to meet customer needs.

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83. Thirdly, the proposed restrictions, whilst having negative consequences, are likely to be rendered ineffective by the carve-out of payment clearing exposures to such financial institutions, which may be very significant indeed. We can see a case for clearing being handled by a separate subsidiary, so that in mixed banking groups, those exposures would be split between ring-fenced and non-ring-fenced banks, with each financially backing in clearing the exposures they individually create.

84. One particular concern is netting arrangements. We presume that consideration will be given to the effects of the operation of and reporting on netting arrangements for the purpose of the ring-fence. Specifically, will netting outside the ring-fence be prohibited? Will reporting be divorced from permissible netting within groups? By this we mean where there are separate subsidiaries and banking entities sitting within a ring-fence, can physical netting only occur within those entities and not in respect of entities sitting outside the ring-fence but within the same group? If so, how will the group as a whole report its arrangements? Will netting be permissible on a reporting basis but not on a physical basis? It is worth noting that one of the salient issues associated with the collapse of Lehman Brothers was the sweeping of cash from one jurisdiction to another at the end of a trading day/trading week – is it proposed that restrictions on international cash sweeps be implemented? If so, presumably the proposal is that, within the ring-fence, cash could not be swept outside the jurisdiction. If so, the argument in relation to potential for international retaliatory measures also pertains here.

85. We would therefore suggest that a better way forward would be a purposive approach: Under this approach any restrictions or limits on exposures to particular financial institutions would be made on a case by case basis, rather than through blanket bans based on the legal form of a transaction or the business of a counterparty, having regard to the needs, circumstances and features of individual ring-fenced banks and the counterparties with which they wish to transact. We think that this outcome would be best achieved through the introduction of bespoke restrictions agreed between individual ring-fenced banks and their supervisors within the purposive approach. Such restrictions would restrict an individual bank from entering into all, or certain specified types, of exposures with specified financial institutions and could be subject to revision on an ongoing basis, whether periodic and automatic, or at the specific request of a ring-fenced bank or the relevant Regulator.

86. Failing that, significant practical discretion should reside at the level of the regulator so that ring-fenced banks are at least able to negotiate and agree with the regulator bespoke exemptions from a more general restriction on exposures to financial institutions (which may be undertaken by reference to permitted types of exposures to particular financial institutions).

87. Finally, we would note that the proposals are significantly different and more restrictive than anything proposed elsewhere in the world. Given the burden of EU, Basel and existing and other proposed UK reforms and the way that they limit banks, we question whether it is in the national interest to “front-run” a series of new and detailed blanket restrictions which there are no signs will be replicated by the major competitive jurisdictions in respect of the banks that they regulate. This could result in creation of avoidable uncertainty and cost and a diversion of effort from the provision of banking services in a way that assists economic recovery and business expansion.

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Consultation Question 4

- **What are your views on the scope of activities to be prohibited? Should any other activities be included or excluded?**
- **What are your views on the conditions proposed for exempting the provision of certain derivatives to third parties from the general prohibition on trading in derivatives?**
- **What are your views on the desirability of permitting ring-fenced banks to sell retail investment products?**

88. As a general point, many of the suggested product restrictions are not aimed at ensuring the integrity of the ring-fence or otherwise furthering the prudential regulation of ring-fenced banks. Rather these product restrictions seem to be driven by conduct of business/consumer protection concerns. Regardless of their merit, we think that it is vital that due account is taken of proposed product intervention powers included in the Financial Services Bill and the revised form of MiFID, and would advise the Government not to "front-run" or cut across these initiatives through its banking reform agenda so as to avoid unnecessary overlap and confusion.

89. An outright prohibition on ring-fenced banks from entering into secondary loan transactions could have negative unintended consequences. Whilst we understand that the Government may have concerns with ring-fenced banks entering into syndicated loan trading, there will be many circumstances where a ring-fenced bank would need to acquire or dispose of loan exposures in order to effectively carry on its business and to provide customer services. Such circumstances would include, for example, account/banking relationship switching, thus negatively impacting other policy objectives.

90. Restrictions on other financial products – and in particular access to the securities markets – could have further unintended consequences as these restrictions might prevent or severely limit retail customers and SMEs access to such products; it seems that the effect would be that these could only be accessed by these customers do through non-bank intermediaries or non-UK regulated banks. Non-bank intermediaries are generally smaller businesses and there may be greater risks for consumers and SMEs in dealing with them, as well as potentially greater costs. . This is particularly pertinent in light of the impact on costs for consumers of independent financial advice pursuant to the implementation of the FSA's Retail Distribution Review.

91. We feel it is important to raise the possibility that non-UK regulated institutions (or less-regulated intermediaries) may find their competitive position boosted by the current proposal and may be able to provide adequate services to fill these gaps. They may have their own differing operational or regulatory constraints, lack awareness or lack experience. Business customers and individuals may both suffer from this situation. As proposed it is again smaller businesses that are likely to suffer particularly from lack of access to basic currency and interest rate hedging products available to larger ones. This will make the development of smaller businesses more difficult especially export orientated ones and could tend to discourage the development of these businesses.

92. With regard to derivatives, the concerns appear to centre on mis-selling. Undeniably appropriately structured and sold hedging products with maturities matched to the primary exposure are useful ways in which businesses, large and small, can reduce exposure to volatile interest rates and exchange rates. The case for limiting the ability of ring-fenced banks to provide such products is not made out in the consultation. Further, it does not require special rules for ring-fenced banks to address mis-selling practices.

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These can be addressed more effectively in other ways, including the application of existing legislation.

Consultation Question 5

- **What are your views on the proposed exemptions to prohibited activities for the purposes of balance sheet management, liquidity management and funding?**
- **What are your views on appropriate safeguards to ensure that this exemption does not give rise to greater risk of evasion of the objectives of the policy?**

93. If a purposive approach is adopted, then the need for complex exemptions should be reduced. See our responses to questions 3 and 4 above.

94. Clearly, the ring-fenced banking entities will need to have available tools to enable them to manage balance sheet risks, manage liquidity and raise funding. The range of exemptions discussed in paragraph 2.47 appears to be the minimum reasonable range of exemptions required to enable normal banking operations.

95. The protections against excessive counterparty risk proposed in paragraph 2.43 do raise a number of questions, many of which result from the use of definitions based on form, rather than a purposive approach. This will require a lot of work and is still liable to produce unintended consequences. For example:

    - Work will need to be done to define a standardised derivative transaction. Would it be restricted to centrally cleared derivatives and/or those subject to ISDA contracts only? Where a non-standard derivative transaction is undertaken, if it is undertaken on arm's length third party basis would that be permissible?
    - Would counterparty credit risk collateralisation be reviewed by the regulator as part of and together with the ring-fenced bank's Tier 1 capital?

96. We consider that each of these questions (and others) will require careful further thought and analysis as to the qualitative and quantitative effects of the relative answers on the ring-fenced entity and wider economy.

97. We are concerned at the suggestion in paragraph 2.43 that restrictions may need to be placed on the laws governing ring-fenced banks' derivative contracts for the reasons noted in response to question 2, and we submit that this proposal should not be taken forward.

98. Care will need to be taken in the drafting of any restrictions in relation to netting arrangements particularly for the purposes of liquidity management as noted in our response to question 3.

99. Given the evolutionary nature of certain derivative products, it is likely that additional derivatives which may be structured for ring-fenced banks could become available which might otherwise be prohibited but which would not contravene the overarching principles of protecting the ring-fenced bank from short term liquidity and other issues. In line with the position we believe to be correct in relation to question 4, presumably the utilisation of such new forms of derivative would be the subject of agreement with the regulator at the relevant time. Otherwise a purposive approach would be likely to reduce the issues associated with innovative products.

100. We agree that a separate limit on wholesale funding for ring-fenced banks at this stage is premature, in advance of the development of the liquidity regime through the Basel Committee on Banking Supervision.

Consultation Question 6

- **What are your views on the principles of ring-fenced bank independence set out in this white paper?**
- **What are your views on the balance between legislation and rules for the purposes of ensuring that a ring-fenced bank remains independent of the financial fortunes of the rest of its group?**
- **What are your views on the advantages and disadvantages of different corporate and operational structures for the purposes of ring-fencing?**
- **What are your views on the appropriateness of restrictions on intra-group transactions discussed in this white paper?**
- **What are the forms of intra-group relationship should the Government and regulator focus on to ensure that the objectives are delivered?**
- **What are your views on the advantages and disadvantages of providing the regulator additional powers over parent undertakings of authorised persons or other unregulated entities for the purposes of the proposals set out in this white paper?**

101. We believe that additional work needs to be done in relation to considering precisely what would sit within and outside any given ring-fence. For these purposes, we believe that in order for ring-fencing as envisaged by the White Paper to operate effectively, it will need to be structural – i.e., ring-fenced entities will need to be separate legal entities sitting within a larger banking group (or operating on their own as an independent separate ring-fenced bank). Given the nature of the proposed prohibitions on activities other than those required to manage balance sheet risks, to manage liquidity and to raise funding, it is difficult to see how a purely contractual structure could satisfy the requirements.

102. Consideration needs to be given as to where particular operating assets are located within any given structure [(and potentially geographically)]. There is, for example, a note that certain subsidiary entities could sit within the ring-fence for the purpose of providing services to the ring-fenced entities. The following considerations arise:

- The operation of service companies which provide infrastructure, IT, employment support and insurance (captives), for example, to ring-fenced banks would arguably need to sit within the ring-fence but, subject to satisfactory protection of the interests of ring-fenced banks, may be more efficiently situated at group level, so as to avoid duplication of expense, increase the resource base of the service company and avoid unnecessary exposures to the other part of a banking group.
- If it were made mandatory for all required support functions to sit within the ring-fence, could those functions also contract with non-ring-fenced entities within the same group (or outside it)? For example, if the operational IT architecture and infrastructure must sit within the ring-fence, can non-ring-fenced banking elements enter into a contract with the ring-fenced bank for the provision of services on the same platform? They may be better located in a separate ring-fence guaranteed on a several basis by the ring-fenced and non-ring-fenced parts of the group, with special protections to cover resolution.
- What will happen to data sharing and holding within and outside the ring-fence also needs to be considered.

103. Further consideration also needs to be given to overseas aspects of banking activities in the context of the ring-fence. If, as proposed, there are to be restrictions on the laws to which certain contracts can be subject what is to happen to existing contracts (it raises difficult legal issues to provide for supervening illegality and it is unlikely to be recognised outside the UK)? And how are ring-fenced banks to provide necessary services in relation to trade finance to customers supplying or buying goods or services abroad? The proposals imply that retail banking operations if conducted in those unauthorised/unapproved jurisdictions must sit outside the ring-fence, but customers who do not qualify to be customers of non-ring-fenced UK regulated banks have no means of getting these services at all unless they are available from non-UK regulated banks. Surely this cannot be intended? In particular, if prohibited jurisdictions are high growth jurisdictions there is a potential impact on the competiveness of the UK banks which must undergo ring-fencing, which has not been analysed but which we believe should be carefully studied and thoroughly costed, from an impact perspective. These matters are of great importance to businesses trading internationally, both large and small, who rely on their banks for services connected with international trade.

104. Indeed, in the context of EU and WTO legal constraints, and with the existence of passporting, we have to question whether UK regulated ring-fenced UK banks would remain competitive in the UK and EEA markets if the proposals are implemented in the form proposed and we believe this risk needs to be evaluated in the cost-benefit calculations.

105. One aspect of the proposals in the White Paper which would benefit from further analysis is the extent to which entities which would on the face of it become ring-fenced banking operations within the meaning of the proposed new legislation are not retail banks, but sit within groups of companies which do not have banking or other financial services as their primary service offering. Many global or multi-national companies have significant global treasury or financial services operations which provide services to the global business, its subsidiary undertakings and joint venture partners. Many of these treasury functions fall under the same regulatory regime as banks. Consideration needs to be given as to whether or not functions such as these will be capable of being carved out of ring-fenced requirements or whether, if a purposive approach is adopted towards legislation different guidelines will be operated by the regulator in relation to the approvals process to undertake relevant activities in respect of these entities.

106. In addition, there is also a need to consider adjunctive retail banking: retail groups such as (for example) Marks and Spencer or Tesco currently provide certain types of banking services, combined with insurance and other services, to their customers. Under the White Paper proposals, it is likely that certain of these services provided will fall within the ring-fence. Again this requires further analysis, and a purposive approach to legislation may assist in providing required flexibility for retail groups which do not have banking as their primary aim or primary business to be able to continue to provide the sorts of competitive services to customers that they currently provide. Care however will need to be taken that ring-fenced retail banks are in some way able to offer competition for these services. It is not currently clear on the basis of the prohibitions proposed whether certain elements of the insurance based services (for example offered by non-traditional challenger institutions like the supermarkets) could be offered by a retail ring-fenced bank. This could have result in an unintended reduction in competition. Analysis should be conducted of the variety and breadth of "group embedded" or "non-primary" retail bank or similar service type operations, and of the impact of the proposals upon them. This will have a significant input into an analysis of the impact of the proposals on competitiveness in the market generally and in specific areas, such as insurance.

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107. The current large exposures regime requires that no single exposure should be permitted to exceed 25% of the bank's capital. This rule applies in any event to separate legal entities within a banking group in relation to exposures to parties which are part of the bank's own group (subject to some exemptions). Exposures to other members of the bank's own group have to be aggregated into a single exposure where the other entities meet the rules of being "closely connected" to the bank.

108. Where a bank is required to split into two legal entities (where previously its retail and wholesale assets had been held in one entity), then each of the two entities would be restricted by the large exposure rules described above in the amount to which they could lend to each other. The amount would be further restricted by the fact that it is likely that there would be other legal entities closely connected to the two entities which would have to be included in the calculation of the 25% limit.

109. Total separation between the retail and wholesale sides of a banking group and the break-up of a single legal entity means that the large exposure rules will apply and will significantly limit the flexibility of the group to move capital between the retail and the wholesale parts of the banking group. This in turn would probably require a bank to look beyond its group for funding – increasing its overall cost of funding and, in general, having a substantial impact on its capital requirements and its cost of capital.

110. In addition, assuming the add on capital buffers under the CRD are to apply at both a solo and a consolidated level, this will significantly increase the amount of capital a group would have to hold where ring-fencing is required. Several points emerge:

- it is not necessary to have specific legislation in the context of banking separation to achieve this end, provided that the ring-fenced bank is required to be a separate legal entity;
- both parts of the group would be likely to find their cost of capital increased and risk a reduction in the availability of capital (equity or loan) for their business;
- The more elements that are required to be inside the ring-fence, the greater the possibility that other parts of the group will need to duplicate those elements outside the ring fence;
- there is a risk that these effects will lead to increased costs for customers.

111. In an international context this would have cost and competitiveness implications, and would tend to put UK banks at a significant disadvantage to many of their non-UK competitors, which are not forced into banking separation.

112. We suggest that the cost implications need to be reassessed fully, bearing in mind the restrictions arising under the existing large exposures regime, before considering any further restrictions.

113. In the event that despite the large exposure limits, further restrictions are proposed, then clarity needs to be obtained on whether the regulator would set limits on the proportion of its funding that a ring-fenced bank receives from the rest of its group, and for the terms of that funding to be regulated, to ensure the economic independence of the ring-fenced bank, on a case-by case basis or a formulaic approach. Each has merits and potentially adverse consequences. Whatever is decided upon needs to be costed, together with the costs of complying with the large exposure rules.

114. It is difficult to see how a complete prohibition on cross default clauses between different entities within the same banking group, where one entity falls within the ring-fence and another falls outside of it, would be of material benefit. Or how a complete prohibition of

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intra-group netting agreements between ring-fenced and non-ring-fenced derivatives counterparties would work in practice. Clearly, undertaking the relevant intra-group transactions under market conditions would provide a measure of comfort in relation to these issues. The risks of sudden funding withdrawal would be mitigated by the large exposure rules and/or specific rules. However, it is likely that exposures to the rest of the group and a small number of other counterparties will be high as a result of clearing membership resting with the ring-fenced bank. Therefore, proposed limits on exposure of a ring-fenced bank to the rest of its group could cause real difficulties for the management of clearing, for fellow group members.

115. The demonstrability of operational independence and the ease of separation in a period of stress also have implications for the disclosure regime. Broadly, the extent of the ring-fence will need, for operational flexibility purposes, to be a matter for approval by the regulator, and thus the disclosures will need to be made to the regulator. We see no need for the demonstrability of operational independence to be made more widely.

116. For reporting purposes and present purposes we presume that the ring-fence in effect operates in both directions. That is to say, operational requirements on the part of the non-ring-fenced entities and disclosure requirements relating to them will not need to take account of the ring-fenced banks' position, assets and liabilities. Equally if so, there may be regulatory capital and/or operational issues which require to be considered in the context of the cost of operation of the non-ring-fenced elements of any bank which is comprised of both non-ring-fenced and ring-fenced banking elements. We remain concerned as to the effects on competiveness of the UK banking sector as a consequence. We believe that further work is required to assess these likely long-term consequences (both financial and operational) and of the effect that they will have upon the cost of funding to UK businesses and consumers.

Consultation Question 7

- **What are your views on the proposed governance arrangements for ring-fenced banks?**
- **What are your views on appropriate exemptions for firms whose business is predominantly conducted from within the ring-fenced entity?**

117. We are of the view that the role of board independence, and the proposals regarding composition of the board which aim to ensure this, are in danger of being overstated. In particular, we note that although there is a suggestion in the Independent Commission's report that board independence was crucial to the survival of Wessex Water in the face of the collapse of its parent, in fact, Wessex Water owed its survival to the ring-fencing of its assets and debts, which was part of conditions imposed by OFWAT.

118. We agree that the independence of a ring-fenced bank should be underpinned by strong governance, and we accept that the composition of a ring-fenced bank should be consistent with the UK Corporate Governance Code, so that:

- at least half the board of the ring-fenced bank, excluding the Chair, should be independent in the sense contemplated by the UK Corporate Governance Code; and
- the Chair of the ring-fenced bank should be independent on appointment.

119. We do not believe, however, that a case has properly been made for the Government's additional proposals for ring-fenced banks. These go far further than the UK Corporate Governance Code requires and would mandate that:

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A board member should not have had a material business relationship with the ring-fenced bank, or the rest of the group, within the last three years.

120. Although the Code contains some similar language, it applies to consideration of whether individual directors are to be considered "independent". This proposal should only apply in the assessment of whether the composition of the board meets the threshold of being "at last half" independent (see *a.* above), and not to the totality of board members.

No more than one third of the members of the ring-fenced bank's board should be representatives of the rest of the group (either as board members of the wider group or executives).

121. Whilst confining the group's representation on the board to a third minority would certainly serve the purpose of restricting the group from exerting undue influence over the ring-fenced bank's board, we do not agree that it is sufficient to address the need to represent the ring-fenced bank's interests within the main group or to ensure strategic coherence with the rest of the group.

122. Indeed, the imposition of such a limit would leave the board of the parent company in the invidious position of having ultimate responsibility for its ring-fenced subsidiaries, but unable to influence, let alone control, their business or affairs. As a matter of good governance, if the parent board has ultimate responsibility for the ring-fenced subsidiary, it should retain some mechanism of ultimate control.

123. These proposals would result in *de-facto* separation and (in the longer run) the possibility that some banks would move out of retail banking altogether. The proposals do not appear to recognise that the parent can be a key source of capital for the ring-fenced bank and that it is responsible to its own shareholders for its performance. It cannot abrogate those responsibilities and needs to have the means to exercise its rights in that regard. It seems to us that there are other means of ensuring independence while enabling the parent company board to maintain sufficient control.

124. One option might be to leave day-to-day management to the board of the directors of the ring-fenced entity, but to provide a mechanism which would enable the parent company to appoint a special director or manager to exercise its ownership interests in defined circumstances. We accept that the setting of pay structures and risk appetite for the firm should be primarily a matter for the ring-fenced bank.

125. Overall, the proposals do not give proper consideration to the duties, responsibilities and obligations to which directors are already subject under the *Companies Act 2006*, in equity and at common law.

126. We accept that an additional regulatory requirement could be imposed through the approved persons regime which would require directors of the ring-fenced bank, when acting as such, to:

- act independently of the parent company or controlling shareholder and exclusively in the interest of the ring-fenced bank; and
- where potential conflicts exist between the interests of the ring-fenced bank as a ring fenced business and those of other group companies, to ensure that, in acting as directors of the ring-fenced bank, they have regard exclusively to the interests of the bank as a ring fenced business.

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127. It is not apparent, however, that these duties would alter or enhance the panoply of duties already imposed on directors through sections 170 to 181 of the *Companies Act 2006*.

128. Furthermore, we would expect the regulator to already be scrutinising the behaviour of directors closely to ensure they are running the business in the right way. The approach document of the Prudential Regulation Authority (*PRA*) indicates that it will seek to evaluate, challenge and where appropriate intervene in the business models, strategies, management, culture and governance of the firms it supervises, in a more proactive manner than has previously been the case. This is clearly a continuation of the intensive supervisory approach adopted by the FSA in response to the perceived failings in its supervision of Northern Rock. In this regard, we understand there have already been instances of supervisors being present at board committee meetings as observers.

129. The Statements of Principle for Approved Persons currently provide a mechanism to enable the regulator to sanction directors for failures to exercise due skill, care and diligence in managing the business of the firm for which they are responsible in their controlled functions, and to take reasonable steps to ensure that the business of the firm for which they are responsible in their controlled functions complies with the relevant requirements and standards of the regulatory system.

130. We also note that under the new financial services legislation, it is intended that the regulator will be given important new powers to direct otherwise unregulated parents of PRA authorised firms where it considers that the acts or omissions of the parent are having or may have a material adverse effect on the regulation of the PRA authorised firms (in pursuance of any of the regulator's objectives). The direction may require the taking of specified action, or refraining from taking specified action, and may require review or remedial action in relation to past conduct. The regulators will also be able to make rules specifying information to be provided to the regulator by parents, although this falls short of requiring publication of such information (for which a direction would be required).

131. These powers will give the regulators ample power to control any actions of the parent that are detrimental to the ring-fence.

132. With regard to board committees we note that similar duties will rest on members as when the board meets as a whole and we would expect there to be separate remuneration and risk committees. Some board committees will, of course, need to interact with the parent: for example audit and pensions are areas where there will be group requirements to be considered in order to comply with law in those areas and/or because common arrangements will remain appropriate after ring-fencing. It also seems clear that these must be able to operate effectively.

133. We agree that any restriction which is to be imposed on cross-membership should not apply to the boards within a group of ring-fenced banks, and that there could be greater flexibility in governance arrangements where a ring-fenced bank represents the overwhelming majority of a group’s business.

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Consultation Question 8

- **What are your views on the proposals for disclosure requirements for ring-fenced banks?**
- **Are there specific areas of disclosure that should be required in order to demonstrate the independence of the ring-fenced entity?**

134. We agree that there may be value in requiring ring-fenced banks to disclose relevant information which helps to demonstrate that they have in place a strong and effective ring-fence. This is qualitatively different from demonstrating 'independence'.

135. The question of whether the ring-fence in place is effective seems to us, however, fundamentally a regulatory judgment, and not a matter which will necessarily be assisted by a raft of public disclosures over and above those already required or to be required under Pillar III. We expect that the regulator would be closely examining and rigorously testing the effectiveness of the ring-fence.

136. We note that there is also the possibility that European legislative initiatives, potentially in the form of a regulation with direct effect, and possibly aiming for maximum harmonisation, might seek to impose further and potentially duplicative disclosure requirements. There are also some US requirements which could be looked at. We believe, however, since disclosure of confidential business information in the public domain can distort competition without achieving greater public confidence that any requirements for public disclosure (as opposed to disclosure to a regulator) are taken forward in the context of international consensus.

Consultation Question 9

- **What are your views on possible approaches to mitigate the risk of a ring-fenced bank being jointly and severally liable for VAT obligations of its wider corporate group?**
- **What is the potential impact of ring-fencing on banks' carried forward losses?**
- **Are there other intra-group tax exposures that could affect the ring-fenced bank, or other tax issues arising from the creation of the ring-fence?**

VAT joint and several liability

137. The question raised in paragraphs 2.75 – 2.76 raises broader issues than just VAT.

138. In relation to VAT, the concern is that a ring-fenced bank could, by virtue of being a member of a VAT group, be jointly and severally liable for unpaid VAT referable to activities carried on by a non-ring-fenced bank ("NRB"). As the requirement of joint and several liability is one in UK tax law, we believe that the UK would be free to remove the rule for ring-fenced banks so as to reflect their independence within a wider group. It would be a natural concomitant of legislating for economic independence and remove distortions in this regard, which of course would dispose of the concern as regards the banking industry[5]. However, if the concept of joint and several liability did remain, there could be some agreement from HMRC that it would seek first to recover VAT debts from NRBs where the VAT in question related to their activities, to provide some degree of protection to the ring-fenced entities.

[5] It is beyond the scope of this response to address whether removal of joint and several liability only as regards banking groups but retention of joint and several liability (which is not a requirement of EU VAT legislation) for other industries is sustainable.

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VAT grouping- administrative solutions

139. HMRC practice is generally to look to the "representative member" of the VAT group for the VAT due from the group as a whole and so one practical step might be that, as HMRC tends only to look to other entities within a VAT group when the representative member has failed to meet its obligations, to provide that a "ring-fenced" bank cannot be the representative member of the group. However, that of itself would not prevent a secondary liability for ring-fenced banks if, after meeting preferred or secured creditors' claims, the NRBs could not fully meet HMRC's claims.

140. If VAT is properly being accounted for and, in the context of larger groups, monthly payments on account should be made by the representative member, the amount of exposure of ring-fenced banks to VAT liabilities referable to the activities of NRBs should be low if – as they should be - HMRC are monitoring collections in real time. Therefore, one approach might be for VAT grouping not to be available only from a date at which it became apparent that the NRB or NRBs posed a risk for the ring-fenced bank or banks.

VAT grouping-legislative changes

141. If the more draconian view that VAT grouping was to be unavailable at least to some extent where NRBs were concerned, to avoid putting up costs to customers of the ring-fenced banks, we would suggest it should still be possible to VAT group the ring-fenced entities with group entities that were cost rather than profit centres (e.g. shared service centres/group employment companies etc.). Whilst this would mean the investment banking entities comprising all or part of the NRBs would suffer VAT on charges from those cost centre entities, they are likely to have a better VAT recovery position than the ring-fenced retail banking entities in the group.

142. There could be other strategies if VAT grouping is not possible, e.g. seeking to fall within the newly enacted cost sharing exemption or using dual employment structures to try and mitigate irrecoverable VAT. However, the more structured any solution is, the greater the cost/administration required to make it work and we suspect that bringing additional complexity to the internal operations of banking groups is not really what banking reform is meant to achieve.

143. A second possible course of action might be to identify the extent to which the amounts of VAT due quarterly from a VAT group could be said to be referable to the activities of the NRBs and for a deposit or bond for this amount (up-dated, say, yearly) to be posted with HMRC: in return for which HMRC would not be able to go against ring-fenced banks for VAT that had not been accounted for in respect of the NRBs' activities.

144. This would need to be achieved by a statutory change, rather than merely relying on guidance as to how HMRC "ordinarily" would operate VAT grouping rules. This would require an appropriate definition of a ring-fenced bank or other entity intended to be within the ring-fence for tax – and other purposes. If this were to be the preferred route we would expect Parliament to require HMRC to be required to pay an appropriate commercial rate of interest in respect of the funds deposited, in effect in advance, with them under this route.

145. Another possible structural alternative might be whether NRBs could declare a trust over amounts due to them from their customers that relate to VAT or are in respect of VAT, with receipt of such VAT amounts being paid into a blocked account from which withdrawals could only be made by the representative member of the VAT group - again, though, this will result in additional cost and administration. The proposed trust

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arrangement over customer receivables would only provide partial protection, given that it would not deal with VAT liabilities arising under the reverse charge. A related requirement, however, might be for a contractual obligation in parallel to be placed on NRBs to fund the account for any reverse charge VAT arising by reference to their activities with security for such obligation being given in favour of the ring-fenced entities. (In such circumstances from a control perspective, it *would* be preferable for an entity within the ring-fence to be the representative member of any VAT group that is permitted, as this would give it the ability to remove NRBs from the VAT group, e.g. where there is a failure to fund the blocked VAT account suggested above).

146. A third alternative which, if adopted, we would strongly recommend was only imposed in relation to the banking sector (because of the implications it might have for the commercial operations of non-banking groups) would be to impose on each NRB a regular obligation to pay to the representative member an amount of VAT referable to its activities, so that most of the time each individual NRB had put the representative member in funds. In practice there should therefore be no loss to HMRC.

Potential impact of ring-fencing on banks' carried forward losses

147. There could be an impact on carried forward losses arising out of the reorganisation required to achieve the ring-fencing. This could occur through the transfer of a profitable business out of a company with carried forward losses or through the transfer of part of a trading business (with apportioned losses) to an entity which is less profitable than the transferor. As the consultation document points out, this could result in companies in the banking group paying tax earlier than they otherwise would. However, the reorganisation may restrict the use of some losses altogether if it was determined that the trade of the transferor company changes as a result of the reorganisation or if the transferor retains more liabilities than assets after the transfer. Banking groups should not be disadvantaged as regards their use of losses as a result of the ring-fencing reorganisation. HMT should consider amending legislation to preserve the use of losses. Furthermore, this would be consistent with HMT's policy with regard to loss carry forward. As reported in the Guardian of 20th February 2011, the Chancellor has already considered, and rejected, the possibility of restricting the carry forward of losses. If the carry forward of losses were to be restricted, there could be a knock on effect in relation to the valuation of deferred tax assets. A resulting question is whether this would have an impact on regulatory capital and whether an affected banking group would have to raise additional regulatory capital as a consequence of the ring-fence.

Other intra-group tax exposures that could affect the ring-fenced bank, or other tax issues arising from the creation of the ring-fence

Tax group

148. The retail bank ("RB") sub-group will be a sub-group within a larger banking group. Our expectation is that the existing tax grouping rules would continue to allow for surrender of tax losses and for the transfer of assets for no-gain/no-loss across the ring-fence between RB and NRB and we believe that they should do so. We maintain that this should be the policy because the ring-fencing is a restriction on a banking group's freedom to structure its group on a divisionalised basis in order to protect the RB from the failure of the activities of the NRB. It is not intended to prevent the RB from sharing in the upside of being in the same group in the good times. This is evidenced by the continuing ability for RB to pay dividends up to a parent company. However, there is a question here as to whether it is necessary for the surrender of any tax losses to be for payment to meet any concerns outlined in paragraph 2.69. Also, should ring-fencing affect group payment arrangements involving both RB and NRB entities in the same

payment group? Or alternatively, is another solution to allow both types of entities to be covered by the same group payment arrangements, but just prevent a RB entity from being the group company responsible for paying the group corporation tax (the 'nominated company')?

Bank levy

149. As mentioned above, it is not just VAT which raises issues of joint and several tax liability. There is also joint and several liability within a banking group for the bank levy. The charge is based upon the chargeable equity and liabilities of the group in respect of a chargeable period. One company in the banking group will be the responsible member, and this company can be nominated by the group. HMT may want to note that there is precedent for excluding certain types of entities from the scope of joint and several liability of the bank levy. An example of an entity which is excluded is a securitisation company. If a full exclusion from joint and several liability is not appropriate, could the liability of the RB be restricted to its own proportion of the bank levy? Also, would it be appropriate to prevent a RB entity from being the group company responsible for paying the bank levy (the 'responsible member')?

Secondary tax liabilities

150. Banking groups are not exposed to joint and several liabilities alone. In certain situations the RB could be at risk of a secondary tax liability which is the primary responsibility of another member of the group. There are a considerable number of different secondary tax liabilities, and often they attach where the tax is not paid within 6 months of its due date. An example is a case where a non-resident company does not pay its corporation tax on time. Under Chapter 7 of Part 22 of the Corporation Tax Act 2010 (CTA 2010) any member of the same group as the taxpayer company could be subject to a secondary tax liability. There is a question of whether this possibility would be consistent with the objective that the RB is "sufficiently insulated from the rest of its group to ensure that a failure in one part of the group does not prejudice the continuous provision of services the ring-fenced bank provides" (see paragraph 2.52 of the consultation document). If this was considered to be a concern, a difficulty would be the large number of different secondary tax liabilities in the UK's tax code. To keep things simple, a potential solution could be a legislative change providing that a RB cannot be subject to any secondary tax liability where a NRB has the primary tax liability.

Ring-fencing reorganisation

151. The reorganisation required to achieve the ring-fencing could itself give rise to tax issues. Although a transfer may be effected on a no-gain/no-loss basis, a latent de-grouping charge could attach to the transfer and be triggered if there was e.g. a forced sale of RB in a period of stress. While the substantial shareholdings exemption may apply to exempt de-grouping charges that are not chargeable gains, it will not necessarily do so, and other types of de-grouping charge would not be capable of being relieved in this way. Also, some banking groups, particularly those where there is retail business in the current top holding company in the group, may want to insert a new hold-co between the shareholders and the existing hold-co as part of the reorganisation. This could amount to a change in ownership and trigger anti-avoidance provisions which could apply in certain circumstances. An example of such rules is those restricting the carry forward of tax losses, where the change of ownership is quite likely to be coupled with a major change in the nature or conduct of the trade or business of various group entities as a result of the reorganisation. There may also be an issue here with regard to the sale of lessor rules in Chapter 3 of Part 9 CTA 2010.

152. In a broader context the problem of a new holding company insertion potentially restricting the carry forward of tax losses is not new. It is one we have raised in the past in different contexts and we would like to take this opportunity, once again, to suggest a change of law in this regard. Paragraph 1(7) of Schedule 7A TCGA 1992 provides an exclusion from the scope of the pre-entry loss rules for the insertion of a new holding company over a top holding company in a group. It is our view that it is worth considering the merits of a similar exclusion to the change in ownership of a company in Chapter 7 of Part 14 CTA 2010.

Transfer pricing

153. We note that the consultation document refers to the potential for transactions between RB and NRB being "undertaken under market conditions" (paragraph 2.69) and that the ring-fencing reorganisation, which will split activities into different entities, may create additional intra-group transactions. We suggest that ways of alleviating the compliance burden, that increased transfer pricing will involve, should be looked into. Particularly if transactions between RB and NRB have to take place at arm's length for regulatory reasons.

Carrying on a banking business

154. There are a number of places where a taxing statue is concerned with whether a person carries on a “banking business” (or a related expression). By way of example:

- section 159(4) CTA 2010, which can apply in the context of determining whether a person is an “equity holder” for the purposes of the rules relating to group relief and consortium relief, refers to whether consideration is provided by a “bank” in the “normal course of banking business”;
- section 453(4) CTA 2010 excludes from the definition of “participator” a person in relation to debt or loan capital provided to a company if that person has acted while “carrying on a business of banking” in the “ordinary course of that business”.

155. It is now many years since Lord Denning, in *United Dominions Trust Limited v Kirkwood* [1966][6] and Megarry J in *Royal Bank of Canada* [1972][7] offered some guidance as to what might be regarded as being in the “ordinary course” of a banking business, and it would seem that the imposition of the ring fence might render this guidance somewhat outdated. On the basis that the policy intention is to protect RBs, but not to hamper NRBs, the reform may therefore present an opportunity for HMRC to update guidance on what constitutes a banking business in its ordinary or normal course. For instance, it would seem that commercial lending undertaken by NRBs should be regarded as falling within these provisions. If this is what is intended, it would be very helpful if this could be made clear in appropriate guidance issued by HMRC.

156. Also, as a general matter, HMRC may like to consider reviewing legislation which refers to "banking business" to see if it needs to be changed in the light of these developments.

Capital loss absorbency and bail-in powers

157. Subject to the following point, we make no comment about capital loss absorbency and bail-in powers in relation to taxation as this is the subject of a separate tax consultation and we are awaiting a policy decision from HMT. However, one point that has been made in relation to that consultation, which has greater relevance to the discussion

[6] United Dominions Trust Limited v Kirkwood [1966] 2 QB 431, CA.
[7] Royal Bank of Canada ([1972] 1 All ER 225.

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above, is the concern that the issue of debt subject to bail-in powers may lead to a de-grouping. It is hoped that a tax law change can be made to ensure that there is no such de-grouping.

Consultation Question 10

- **What are your views on alternative ways of ensuring that ring-fenced banks are not subject to joint and several liability in relation to pension deficits?**
- **What are your views on an appropriate date by which firms should be required to separate their pension schemes? Would 2025 allow banks sufficient time to mitigate the costs of a separation?**

158. It appears to us that, without over-riding legislation for this particular sector (which would be an unusual course), the only two structural options for isolating ring-fenced banks from other group entities' liabilities are:

- de-merger; or
- sectionalisation of schemes.

159. There is a degree of flexibility within each general structure. There are, however:

- some common and fundamental legal points to be addressed under either approach; and
- a number of issues will still remain unresolved, which will require additional measures to be addressed satisfactorily.

Common legal issues to be addressed

160. In principle there is nothing to prevent segregation of pension liabilities as envisaged.

161. As a matter of law, the liability to fund pension schemes will be allocated between corporate entities, whereas it is by no means clear that ring-fenced banking functions and other group functions will be divided along the same corporate lines.

162. This creates the potential for a mismatch between corporate entities and the businesses which are to be ring-fenced. In turn, this creates some immediate challenges:

- There is a risk that debts will be created under s75 *Pensions Act 1995* when aligning the corporate entities and the businesses to be hived off: is there an appetite to generate immediate and potentially significant liabilities?
- in considering any de-merger or sectionalisation proposal, trustees will need to be satisfied that all pension liabilities are supported by an appropriate covenant afterwards. Any mismatch between corporate structure and business lines makes it very unlikely that the covenants supporting the pension liabilities in the new structures will in all cases be as strong as was the case beforehand. What measures can be introduced to mitigate the impact of a weakened covenant in order to allow trustees to agree to de-merger / sectionalisation proposals?
- There is a related challenge, which is determining the basis upon which existing liabilities will be allocated as between the various corporate entities. It seems inconceivable that all banks' employment records will be so accurate as to enable a clear allocation of historic pensions liabilities, even if the banks' various business lines can be moved into separate corporate entities.

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Additional measures

163. Assuming it is possible to overcome the issues summarised above, neither de-merger nor segregation in isolation will deliver the stated objective in all circumstances.

164. This is because ring-fenced banks will always face the risk of being 'contaminated' by other pension liabilities as long as they remain in the same corporate group that delivers the banks' other business lines. This is due to the anti-avoidance powers that the Pensions Regulator (tPR) has.

165. It will not be possible to achieve the stated objective without either: (i) separating ring-fenced banks out of the corporate groups in which they currently reside; or (ii) either passing legislation to prevent tPR from using its powers to impose liabilities on ring-fenced banks or an irrevocable and binding statement from tPR that it will not use its anti-avoidance powers in relation to such a bank. We would be surprised if tPR felt able to offer such a statement, in the absence of legislation.

166. Our view is that the proposed deadline of 2025 is sufficiently far away to allow banks to mitigate the costs of a separation. This could potentially include the payment of additional contributions to deal with any s75 debt issues and/or formulating funding plans to address any weakening in covenant post-event.

Consultation Question 11

- **What are your views on the appropriateness of applying a threshold below which firms are not required to introduce a ring-fence?**
- **How do you believe that such a threshold should be set?**
- **Where do you believe an appropriate threshold should be set?**
- **What are your views on dealing with firms who approach the threshold?**
- **What are your views on the proposed treatment of building societies and branches of non-EEA firms?**

167. We agree that a ring fence as such is not valuable for *de minimis* activities in groups whose activities are substantially within or outside the scope of the ring-fence. We assume that retail deposit-taking firms, whose activities are substantially those of ring-fenced banks (like building societies) would be subject to the general conduct and activity restrictions falling on ring-fenced banks.

168. The appropriate threshold would probably be best set as a percentage of business exposure. The correct measure is for debate but cost issues should be thoroughly analysed as part of that debate.

169. We would envisage monitoring processes being required by the regulator with firms at certain trigger points being required either to reduce/cap the other activity (e.g. by disposing of or ceasing part of their business) or committing to adopt the dual business structure and set up a separate ring-fenced bank within a defined time-scale.

170. Building societies in several areas are close competitors of retail banks, particularly as regards mortgages, savings accounts and current accounts. Therefore similar regulation would seem appropriate, although it seems unlikely that most would have substantial activities which would require the imposition of a ring fence. The consolidation of building societies in the recent crisis illustrates some of the possible risks that the proposed form of ring-fencing may give rise to across the UK regulated retail deposit

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taking sector. . Like building societies, ring-fenced banks will operate on small margins with high cost of capital and cut off from the economies of scale and scope they may have enjoyed as parts of larger banking groups. These are forces that will tend to commoditization, inability to innovate and relatively high costs and poor returns for customers. As mentioned below in our comment on competition, we cannot see how this will increase competition in the UK regulated retail banking sector, or stimulate growth in the wider economy. We fear that both UK regulated retail banking and the services of building societies are set to stagnate under the proposals.

171. As regards branches of non-EEA firms, there is no mention of the commitments that the UK has in respect of financial services under the World Trade Organization GATTS. Whether the proposal is practical depends on whether it is consistent with the UK's international obligations, which would normally prevent requirements to adopt particular forms of legal entity through which a service must be supplied (Article XVI:2(e)). We note, however, that if such banks have subsidiaries established and regulated elsewhere in the EEA they would be entitled in any event to provide retail banking services in the UK through the passport without adopting a ring-fenced structure if not required by their lead regulator. There are questions therefore as to whether the measure would contribute to achieving its intended objective. It could lead to some friction with the governments and regulators of the home countries of these banks and potentially damage the interests of UK regulated banking groups in those other countries.

172. Again we note that this aspect appears not to have been considered or costed in the impact assessment.

Consultation Question 12

- **Should a scaling mechanism be applied to the ring-fence buffer and ring-fenced bank PLAC requirement, including in the context of a ring-fence *de minimis* (see Chapter 2) being applied?**
- **What might be appropriate additional metrics for assessing the resilience of UK- headquartered G-SIBs' domestic entities – both ring-fenced and non-ring-fenced – against the failure of overseas entities?**

173. We consider this is a technical question for specialist economists, but it is clear to us that the decision in this case will affect the cost of the ring-fence. Therefore it has the capacity of flow down into higher costs for customers of ring-fenced banks. We urge, as with other aspects, that there are detailed case studies on the impacts on customers of the different variables alone and in combination and that efforts are made to limit the costs to customers.

Consultation Question 13

- **Should particular liabilities be excluded from the bail-in tool, in particular unsecured liabilities with an original maturity of less than one month and derivatives?**
- **What steps could be taken to help ensure that debt issued under foreign law could be bailed-in by the UK resolution authorities if necessary?**
- **Would a broad statutory bail-in power give sufficient clarity to market participants to enable them to appropriately price risk?**
- **Would an approach of the type described in paragraph 3.40 enhance the usability of the bail-in tool?**

- **What steps could be taken to promote the development of a market in contractually subordinated debt to be bailed-in prior to senior unsecured debt?**
- **What ex ante steps could be taken to limit the risk of contagion following a bail-in?**
- **If the addition to the statutory bail-in tool described in paragraph 3.40 is taken forward, should there be a phase-in period to give institutions time to build up their PLAC requirement through the issuance of such subordinated instruments?**
- **Should senior unsecured debt with 12 months remaining on its term be permitted to count towards PLAC during a transition period and in the longer-term?**
- **What characteristics should existing subordinated debt that is not eligible to count towards AT1 and T2 have to be eligible to count towards PLAC?**
- **Under which circumstances could it be advantageous to undertake: (i) a top down bail-in (i.e. bail-in at holding or top company level) and (ii) a subsidiary level bail-in? What are the practical implications of these alternative approaches?**
- **What creditor safeguards should apply to bail-in?**

174. There has already been wide consultation, at European level, on bail-in and so many of the issues raised in the White Paper have already been addressed as part of this consultation. We refer in particular to the City of London Law Society response[8] dated 20 April 2012 to the working document of the European Commission, DG Internal Market on bail-in as a debt write-down tool (see footnote for link) and to the letter dated 26 April 2012 from the Law Society to the DG Internal Market, European Commission[9] (together the Bail-in Responses). We repeat the points made in both of those responses.

175. We also consider that the legal framework in respect of bail-in will be driven by European law (and in particular the Crisis Management Framework Directive) and so we query why HMT is seeking views on this topic at a domestic level. As mentioned in the Bail-in Responses, we think it is essential that there is a consistent approach to this topic, not just at a European level but more widely, and so we think it is important that any actions that the UK might take in this regard are consistent with other international developments.

176. Given the detailed positions set out in the Bail-in Responses, we have not addressed all of the sub-parts to question 13 but instead we would make the following points of principle:

- As referred to in the Bail-in Responses, we would stress the need for legal certainty, predictability and transparency regarding the treatment of shareholders and investors in financial institutions so that they can make informed decisions regarding the risks associated with their investments. Otherwise there is a risk of higher funding costs and a decrease in the competitiveness of UK (or European) banks. We do not consider that a broad statutory bail-in power would give sufficient clarity to enable market participants to appropriately price the risk they are taking.
- We consider that there is an irrevocable conflict between the idea of respecting the hierarchy of claims in a bank insolvency and a wide statutory power of bail-in which will inevitably involve carve-outs and exceptions. In terms of what these exceptions should be, we refer to paragraphs 16 to 46 of the CLLS paper. We note that the

[8] CLLS (2012). '*Response to the working document of the European Commission, DG Internal Market, on bail-in as a debt write-down tool*', pub: City of London Law Society, accessed at:
http://www.citysolicitors.org.uk/FileServer.aspx?oID=1169&lID=0
Also see Annex IV for the link to access the full response, on the CLLS website.
[9] Please find a copy of this letter in Annex III.

Government is proposing that derivatives should be excluded and we agree with this, even in relation to any net amount that might be due from the bank, because of the difficulties of valuing such amount within the resolution weekend. We consider that the same valuation issues arise in respect of the unsecured shortfall element in respect of any secured debt. We also consider that short-term liabilities should be excluded, but we think that the relevant cut-off period should be 12 months and not 1 month. We consider that all deposits should be excluded, not just guaranteed deposits, as should trade creditors who would not tend to be compromised in a corporate consensual restructuring. We would point out that, if depositors and trade creditors are within the scope of the bail-in powers, there is a risk that these counterparties will seek to move their positions at the earliest sign of trouble (rather than risk being bailed-in), thus causing a potential run on the bank.

- For the reasons set out in the Bail-in Responses, we consider that bail-in should be confined to categories of debt with a known principal amount and where the holders have notice from the date of creation of the debt that the bail-in regime could be applicable. If the debt instrument contains an express contractual provision referring to the possibility of the debt being bailed-in (without going into details as to what the debt might be converted into), this will also assist when it comes to cross-border recognition of the bail-in outside of Europe. Hence we are supportive of the proposals in paragraph 3.40 of the White Paper except that we consider that this should not be in addition to a general bail-in power in respect of other categories of debt.
- We note that deposits are the "stock in trade" of a banking business and therefore unless specifically agreed, the idea that deposits and other core banking obligations, such as the obligation to make loans under agreements with customers who meet the agreed conditions for borrowing can be made subject to bail in, does not appear to have been thought out. It appears to contemplate that a business customer would accept a situation where it continued to deal with a bank to whom it had to repay its loans in full, while not getting back its deposits in full and being effectively deprived of its netting rights. This is the similar, conceptually, as if a manufacturing business that has been reconstructed expected a customer to pay the full agreed price for, say, an aircraft and accept delivery of an incomplete plane (e.g. without wings). If a bank as a whole that is the subject of reconstruction measures or a bridge bank containing viable business is to continue in business they must continue to meet their viable trade obligations in full and that means paying out the depositors in the continuing business in full, regardless of whether they fall within the FSCS guarantee, as well as meeting obligations to lend in full and not creating mismatches in relationships with customers that involve deposits, lending and netting arrangements. Merely because a bank's stock in trade is financial obligations, it does not mean that they can be treated differently from the order book and stock in trade of a manufacturing business in the context of rescue and reconstruction. A banking customer that has not got what he bargained for in relation to a continuing banking business will take his remaining money and his banking relationship elsewhere at the first opportunity, so jeopardising the prospects for the reconstructed bank.
- Finally, we consider that the other resolution options contained in the Banking Act 2009 and the Crisis Management Framework Directive (such as transfer to a bridge bank) should mean that bail in is confined to the circumstances where creditors of a company undergoing a scheme of arrangement could be expected to accept bail-in type arrangements in order to rescue a business in whole or in part: it has no part in relation to a bank where the whole business goes into special administration or as regards obligations left behind in the failed business, after viable parts of the business have been transferred to a bridge bank or third party. The ordinary insolvency rules on priorities and distributions should apply to businesses or parts of businesses that are not rescued and reconstructed. There seems to us no need to have wider powers (as proposed) that would cause conflict with the "no creditor

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worse off" standard, by applying a different framework of rights and priorities to claims against the insolvent part of the bank, as opposed to the rescued part.

Consultation Question 14

- **Should depositor preference be extended beyond insured deposits to include the equivalent sum of non-EEA deposits (i.e. the first £85,000 of these deposits, regardless of local insurance scheme limits)?**
- **Is there a case for preferring one or more groups of senior unsecured creditors alongside the FSCS, for example banks' own pension funds, or charities and/or local authorities? Are there any compelling reasons why these newly preferred creditors should not rank *pari passu* with currently preferred creditors?**

177. We do not support the idea of depositor preference for guaranteed deposits. We consider that bank insolvency should be subject to the same rules (including those in relation to the hierarchy of claims) as apply in relation to general corporates. From a policy perspective, retail depositors are already protected, both by the FSCS guarantee scheme and the focus on the transfer of the deposits to a third party bank in the SRR and the special bank insolvency process. Hence the only real purpose of giving the guaranteed deposits priority would be to prioritise the subordinated claim of the FSCS (and therefore reduce the levy imposed by the FSCS on other banks). However, this will be at the cost of the non-prioritised creditors of the failed bank, some of whom will be other banks that will benefit from the reduced FSCS levy but many of whom will not be (for example suppliers who may be SMEs). Such a situation will mean the creditors of the failed bank bearing the cost associated with giving the guaranteed deposits priority, instead of the cost of the FSCS levy being borne by the banking industry more generally.

178. We agree with the concern expressed in paragraph 3.65 that giving the guaranteed deposits priority could give rise to adverse and disproportionate consequences for other creditors (such as pension trustees, local authorities and charities). However, it risks opening the floodgates if priority is given to creditors who would not have priority in an ordinary corporate insolvency. Recent changes in insolvency law have been intended to limit preference to a very few categories of creditor, and we do not see the case for a policy reversal in this regard made out.

179. Insolvency law provides for a fair distribution of the assets of an insolvent business. Once it is clear that a bank or part of it is heading into insolvency, the normal rules will apply. This is not to suggest that those who fund and underwrite the FSCS scheme should be without rights in the insolvency: they should stand in the shoes of the depositors they have paid out, who are unsecured creditors. They will thus probably be the largest unsecured creditor in any bank insolvency with appropriate powers in relation to the appointment of administrators and on the creditors committee, but the case for priority over other ordinary creditors is not made.

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COMPETITION

180. While there are no specific questions in relation to competition, the discussion proceeds on the assumption that the proposals will be helpful to competition. As presently formulated, there are questions as to whether they will result in a 'step change' in competition, indeed there is a possibility that the result may be the opposite of what is intended.

181. We have already alluded to this in the final paragraph of our response to question 7. We have noted that the reforms as presently proposed will impose high regulatory costs on ring-fenced banks and limit their ability, in some respects, to respond to customer needs or adapt to changes. These effects will be over and above those of a similar nature stemming from the enhanced cost of capital that all UK regulated banks will face, not just as a result of Basel requirements, but because of other measures e.g. bail-in. The impact of depositor preference for FSCS guaranteed deposits, if implemented, will also impact on the cost and availability of other deposits and loan capital and this burden could also fall almost entirely on ring-fenced banks. On the operational side, major expenses, such as money movement technology and clearing systems, are all planned to fall within the ring fence as will the branch network costs, but other parts of the same banking group will no longer be integrated in a way which might justify them contributing to development and running costs.

182. Without careful work being done as to how to ensure that ring-fenced banks are able to access capital effectively and at a reasonable cost (e.g. by abandoning depositor protection and carrying out detailed work on customer needs and ensuring that there are sufficient flexibilities to enable them to be met in an affordable way) these reforms may generate some negative unintended consequences on consumers and SMEs (through their impact on the retail banking sector) with the high cost of these proposals impacting on both competitiveness and the cost of services to customers.

Effect on retail banking services supplied by UK regulated banks

183. Ring-fenced banks facing higher costs and the risks created by bail-in and depositor preference are likely to face significantly higher prices for long-term unsecured debt, which may impact on affordability of this category of debt. , The higher cost of this debt would reflect the risk of re-characterisation involving write-off or conversion into risky equity and the heightened risk of a nil or smaller recovery in insolvency as a result of preference for FSCS guaranteed deposits. Cheaper secured debt will only be able to be raised to the extent suitable assets are available and to the extent that there are no prudential restrictions on the creation of security over core assets. Assets of the types used in covered bonds are likely to be found to a much greater extent outside the ring fence, given the proposed restrictions on the activity of ring-fenced banks .

184. A separate consultation proposes that building societies are, broadly speaking, subject to the same business restrictions as ring-fenced banks and will therefore face similar costs, though perhaps less one-off costs of reorganisation, since their businesses already accord more closely to the ring-fenced bank model. In any event the building society sector's business model has been vulnerable to both the low interest rate environment (where lack of business diversity has made it very difficult for them to earn the rates of return needed to pay attractive interest rates to savers) and to some extent to the "borrow short, lend long" problems faced by Northern Rock, because of their dependence on short term depositors for significant part of their funding. There have been a few failures and considerable consolidation in the sector reflecting that

economies of scale needed to survive in this environment. This is despite the fact that, to date, building societies have not been exposed to bail-in or legally binding guaranteed depositor preference, which would reduce their ability to raise medium term unsecured debt at reasonable rates from investors.

185. Ring-fenced banks may face similar pressures as have been experienced by building societies, even before consideration of the additional features being introduced with ring-fencing.

186. The government needs to urgently consider the impact of the current proposals on potential new entrants and whether they may be deterred from entry. In addition, the possibility that current participants may look to merge to gain further cost-saving opportunities also needs to be considered. They may also be deterred by other aspects of regulation under consideration: e.g. the EU proposal that resolution of a bank can extend to its parent company, seems likely to deter large retailers (which already have their own economies of scale and scope into which a banking business fits well) from entering or staying in this market, as separate forces, though they may be prepared to provide services at their premises for an unrelated bank in return for fees.

187. The fact that the separated non-ring-fenced parts of a banking group will be limited in its dealings with the ring-fenced part (including the possibility of giving or receiving emergency funding) by the large exposure rules, or the exposure restrictions proposed in the White Paper in the same area, might encourage these groups to consider exiting retail banking in the UK or lead some to merge with other ring-fenced banks. Neither scenario offers the possibility of more retail banks.

188. We urge the Government to consider the possible following additional knock-on effects of the ring-fence proposals in their calculations over where best to place the ring-fence:

- The activity restrictions could impact negatively on product innovation;
- The cost of capital is likely to result in higher charges for banking services. However, given the structural limits on activities and the same basis of capital requirements, these charges would be likely to be much of a muchness. Absolute higher costs are not, however, normally associated with effective competition;
- Cost pressures seem likely to reduce service standards and could lead to job losses and branch closures, as well as greater use of off-shore support services, such as call centres, even without considering the impact of any permitted consolidation. Again this does not provide any objective consumer welfare.

Competition from outside the Ring-fenced banking sector

189. There may well be entry from EEA regulated banks that do not have super Basel capital costs or ring-fencing requirements. Such entry would expose customers to non-UK depositor protection. Recent experience with Iceland, an EEA country, suggests that there could be problems with this. There are also risks of cash being swept abroad (as in the case of Lehman). UK regulated banks could set up new EEA banking subsidiaries to take advantage of these possibilities, but this carries these risks, even if modified so long as the parent remains a UK company.

190. There are a variety of non-banking businesses that offer services that may substitute for those of a bank (e.g. money transmission, crowd-lending, loan brokering between private parties, some credit card operations, some electronic money operations). However, none of these, under the current legal framework, would offer the same degree of security for the consumer/business user as a bank. In addition EU work on shadow banking may result in a number of these coming into some form of closer regulation. The

first failure in which consumers lose money (that would have been safe if they had been dealing with a bank) will likely lead to pressures for such businesses to be subject to the same degree of regulation as banks, which would seem likely to undermine their business model.

Consequences for Customers and particular consequences for business

191. The cumulative impact of the cost of borrowing and greater capital reserves will – as the IA in the White Paper suggest – be lower levels of lending. In turn this will impact business and in particular smaller business (such as high street law firms and their business clients) who currently have their sole banking relationship with a UK regulated bank and would become customers of a ring-fenced bank.

192. Depending on the exact outcome of the various proposals canvassed, there could be additional effects: for example, netting arrangements with business customers can currently cover all types of account in the UK and in other places where a customer has an account with the same bank or banking group. These are extremely efficient both for the customer and the bank/banking group. However, following ring fencing:

- a large corporate customer staying with the same group will have much of its relationship with the other side of the ring fence and presumably netting across the ring fence will not be allowed. But because current account management and money transmission seems likely to be a province of the ring-fenced bank, the large corporate may not be able to get all his banking relationship onto the other side of the ring fence;
- a smaller corporate customer may suffer in the same way – for example if it has a business and an account with a member of the banking group outside the EEA. Even though the nature of the overseas branch might make it much more suitable to be part of the ring-fenced business, this would not be allowed;
- parts of the group outside the ring fence would have to deal with the ring fenced bank at arms-length, as if unrelated: this reduces the incentives for both banks to deal with each other and share economies of scope and scale with customers. Customers of the ring-fenced bank over time are likely to pay more and find no advantage in dealing with a bank in the same group;
- it is not clear how easily ring-fenced banks will be able to meet the needs of smaller business customers in relation to foreign currency and letters of credit, when they are at arms length to their group network, particularly if there is doubt about contracting under non-EEA laws.

193. All the above suggests that the incentives for business customers to use non-UK regulated banks/banking groups will increase , with EEA banks having preference, unless others can offer greater security for unsecured deposits (e.g. because there is no deposit bail-in, contrary to current UK and EU proposals).

Effects on competition in other markets

194. It is well established that short supply and a high cost of loan capital impinges on the ability of businesses to expand. In particular, if it is more difficult to start up or enter a market e.g. because risk capital is not available at the right price in the right quantity then competition is affected. Indeed, if the specific type of ring-fencing proposed does make banks more risk averse, small firms may find it difficult to find alternative forms of capital. It will take time for banks regulated outside the UK to get the market experience to fill any gaps. Further, in difficult times they are likely to retreat to their home market e.g. if

they themselves face liquidity issues. This has happened with EU banks operations in UK domestic lending markets as a result of the Euro-crisis.

195. Currently the Government is providing low cost loans to banks for business lending to help to counteract shortage of lending for business growth in the UK market. The possibility of a specific business bank with Government backing is being discussed. The question whether regulation that intensifies these effects can be good for competition and growth in the wider economy has to be asked? In any event the long term costs to Government of such measures would need to be factored into the impact assessment.

ANNEX I: IMPACT ASSESSMENT

INTRODUCTION

196. We welcome the opportunity to comment on the Government's impact assessment (IA) of the proposed banking reforms. Overall, the IA adheres to the fundamental framework of cost and benefit analysis (CBA), in particular:

    - the key parameters of the policy options which are likely to have a significant impact have been identified and clearly articulated. (However, the precise scope of the Government's proposals have yet to be defined, and precise details as to implementation are also highly relevant to the optimisation of the Government's proposals and thus any CBA.);
    - the impact of the policies are assessed against the correct baseline, "the regulatory baseline scenario", which takes into account current national and international regulatory developments;
    - the nature and the source of certain costs and benefits arising from the policies are clearly set out (the emphasis on “certain” is deliberate), and analysed incremental to the regulatory baseline scenario;
    - some of these costs and benefits are quantified and monetised;
    - a number of the assumptions underlying the cost and benefit estimates are set out, and some sensitivity analysis has been carried out to provide ranges for the various costs and benefits; and
    - some of the wider impacts of the proposals have been considered.

197. IA is a key tool in policy analysis. Given the far reaching consequences these policy proposals will have on the UK financial sector, and the vast potential for unintended consequences as customers and suppliers adapt to these very wide ranging proposed reforms (which also interact with an array of other UK, European Commission and global regulatory developments), the importance of a rigorous analysis cannot be over emphasised. In these circumstances, impact analysis is very important. The IA tool can help to further the decision-maker's understanding of the wider implications of the range of options, and therefore contribute to ensuring that the final package of banking reforms is proportionate and optimal in terms of benefits, costs and associated risks. In this regard, we believe that further work should be done to strengthen certain areas in the IA, namely:

    - there are issues with the Government's implementation of the CBA framework;
    - the IA does not provide a complete assessment of the costs of the proposed reforms; and
    - the assessment of the risks and unintended consequences needs to be more comprehensive.

198. To put these points in context, the impact assessment already anticipates annual costs to UK banks of £4-7 billion and an annual GDP costs of £0.6 billion - £1.4 billion. Ensuring that these costs are minimised by paying close attention to the precise implementation of these proposals is self-evidently important given the magnitude of these sums, and the unintended consequences of these proposals may compromise the claimed benefits.

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IMPLEMENTATION OF THE CBA FRAMEWORK

The appraisal of the "regulatory environment baseline" is incomplete

199. We acknowledge that the baseline scenario has been carefully specified to ensure that it has regard to the broader reform agenda both at the EU level and internationally.[10] Although the majority of regulatory reforms have been included in the baseline scenario, the Government has chosen not to include the EU work on bail-in in the baseline scenario because it is yet to be finalised.[11]

200. However, it is not satisfactory for the IA to carry out purely an illustrative calculation which assumes that the regulatory baseline reduces the probability of further crises by 30% and the ICB implementation by a further 10% and the cost to GDP of a future crisis by 25%.[12] No evidential basis is advanced to support these illustrative calculations, and carrying out some sensitivity analysis does not provide any comfort since no evidential basis has been advanced as to what assumptions or range of assumptions are reasonable. Of course, implicit in these calculations is what economists might describe as a “heroic” assumption as to when the next banking crisis would otherwise emerge.

201. Even on an illustrative basis it would be sensible to list the entire array of matters which are included in the regulatory baseline and consider the incremental costs and benefits of implementing the Government's proposals, focusing on how they reduce both the probability of future crises and the GDP cost of future crises. In this regard, it is important to bear in mind that individual policy parameters may be both complementary and substitutable to varying degrees. For example, increasing loss absorbing capital and bail-in may have a degree of substitutability (both may potentially increase loss absorbency, albeit that there are real risks of unintended consequences with bail-in, see further below). Similarly, the IA should be explicit about the added value of the various elements of the Government’s ring-fencing proposals to reducing the costs of future crises on top of measures such as “living wills”.

202. Clarity would be added as to the incremental costs/benefits of the Government's proposals if these were to be appraised individually as regards each of the key elements (e.g. increasing loss absorbing capital, ring-fencing, bail-in etc). The CBA could then take account of any complementarities between these measures, i.e. if the combined effect of the package of policies measures is likely to be greater than the net impact of individual reforms.

203. The importance of correctly considering the additional benefits of the Government's proposals, in addition to those associated with the baseline regulatory environment, cannot be overemphasised.

Only one implementation option for the ICB recommendations has been considered in the IA

The government’s lead policy option[13]

204. We appreciate that a complete assessment of the full range of alternative formulations of each policy variable (including different combinations of these policy variables) might be

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[10] This purpose of this approach is to ensure that the IA assesses incremental impacts of the proposed reform option, to the "do nothing" option (where no action is taken and UK regulatory environment reflects only the reforms underway at the EU and international levels).

[11] Paragraphs 13 to 15, Annex A of the White Paper.

[12] See paragraphs 91, Annex A of the White Paper.

[13] See paragraph 20, Annex A of the White Paper.

challenging. However, understanding the relative costs and benefits attached to different policy options is key to ensuring that the least costly reforms are chosen – particularly given the scale of the costs. A number of options should be shortlisted and appraised. Responses to the consultation could then be used to inform to the choice of shortlisted options.

205. Moreover, the Government Green Book on policy appraisal advocates that "do minimum" options should be considered as part of the set of options to provide justification for more interventionist actions.[14]

206. Impact analysis should be an iterative assessment which is integrated into the policy development stage, so as thinking develops; options should be adjusted and reappraised. Given the fact that a number of key policy variables are up for consultation, it is important for the Government to revisit the impact assessment in light of the consultation responses, ensuring in particular that there is due regard for uncertainties and unintended consequences.

Evaluation and review

207. It is clear that there are significant uncertainties as to precisely how the package of measures will be implemented, and there are material issues as to implementation which have yet to be resolved. (A number of these are covered in this response.) It is also clear that the Government intends to implement various measures through secondary legislation and by affording regulators substantial discretion. In such circumstances, and given the scale of the reforms, evaluation (both in the short-term and long-term) is an essential part of the policy development life cycle, and should be considered as part of the IA. Evaluation examines the outcomes of a policy to determine what the actual impacts are against the projected impacts. Policies should then be refined in light of new information in order to minimise an adverse impact or enhance a positive impact.

208. In this context, evaluation in the short-term is important. Monitoring and evaluation should be undertaken during the transitional period as banks undergo the necessary structural changes to comply with the reforms. The evaluation should consider (i) whether actual costs of the policy reforms are greater than forecasted costs and (ii) whether any unintended consequences have materialised, and their associated costs.

209. The results of this evaluation exercise should be incorporated into the decision-making process. If appropriate, the reforms should be adjusted during the transitional period to minimise the effect of these risks and unintended consequences. This points towards there being a periodic review mechanism, which will allow these policies to be adjusted in light of actual experience, unforeseen costs and unintended consequences.

ASSESSMENT OF THE COSTS OF THE PROPOSED REFORMS

210. The IA clearly describes a number of key assumptions underlying the costs and benefits. However, some assumptions are too strong; if relaxed, they could substantially affect the costs and benefit estimates.

211. As a general point, the impact analysis should have regard for the current economic and financial environment and the pathway in the medium run and long run. This future development will determine the magnitude of the costs of these reforms. If the macroeconomic and banking environment remains weak or potentially unstable, and issues in the European financial market persist, the pathway to restructuring will be

[14] See paragraph 5.3, Green Book: Appraisal and Evaluation in Central Government.

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difficult, and could compound the adverse impact for the banks, market participants and the wider economy. For example, requiring banks to increase their loss absorbing capital in such an environment – or even generating such an expectation that this will be required in the near future - could curtail their willingness to lend and make them highly risk averse.

Cost and availability of capital

212. The cost of equity used to value the additional capital requirements is based on the long run cost of equity.[15] In many forms of quantitative analysis, historical features of the market may provide some indication of the future. However, in the context of this analysis where there is substantial on-going regulatory and structural reform of the UK and international banking system, which will require significant changes to banks' structures and funding arrangements, it is unlikely that the historical cost of equity will provide a good measure of the future cost of equity. Certainly shareholders' perceptions as to the riskiness of banks' activities in 2012 bear no resemblance to shareholders' perceptions of equity risk in 2007. The Government's withdrawal of the implicit guarantee to banks is also a relevant consideration; even if shareholders have borne very substantial losses as a result of the financial crisis, an expectation that retail banks would not be permitted to fail might have impacted shareholders' assessment of risk.

213. The IA also makes another "strong" assumption that the additional capital required to comply with the ICB recommendations is available to banks[16]. Given the impact of the financial crisis, it is uncertain whether investors have the same appetite for investing in banking capital. Assuming that reducing dividends to raise additional capital can be done with impunity is a strong assumption. Also, given the implications of loss-absorbency reforms, the level of demand for bank debt is uncertain, particularly given the risk that the reforms might damage banks' abilities to refinance maturing loans and debt. The Eurozone crisis is also another significant risk factor as regards further equity investment in banking.

214. These considerations point to there being some sensitivity testing around these points, including as regards the consequences of banks reducing their lending volumes if they are not able to raise the additional capital based on their current liabilities. This will adversely affect many businesses and consumers and reduce GDP.

Bail-in

215. Whist we acknowledge the complexities of incorporating bail-in into the baseline scenario due to the uncertainties of the final structure of the EU bail-in, wrongly attributing all the impacts of bail-may risk mis-specifying the underlying framework of the IA that the subsequent impact analysis is based on.

216. This is a particular issue in that the CBA does not separately identify the costs and benefits of bail-in from the overall claimed benefits and estimated costs.

217. Moreover, the Government should also note that reaching a conclusion on the structure of the UK bail-in regime when discussions at the EU level are still in progress should be taken with care. If the UK introduces bail-in reforms in excess of equivalent regulations at the EU level, it is very likely to affect adversely the competitiveness of the UK banking sector. Debt providers might well have a strong preference for lending to EEA and non-EEA banks which have less onerous and interventionist bail-in regimes, which could

[15] See paragraph 44, Annex A of the White Paper.
[16] See paragraph 45, Annex A of the White Paper.

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cause difficulties for UK banks seeking funding in times of crisis. Accordingly, as suggested in the initial consultation response, where uncertainties exist about the existence or operation of any new EU or international regulatory measure, the impact analysis should consider the situation with and without these EU/international reforms.

Crisis responses and stress

218. We appreciate that there are complexities in modelling how costs of funding will change in a stress scenario. Such quantitative assessment may be subject to various uncertainties, given that the impact of a stress scenario is driven by numerous unknown parameters[17] which are difficult to predict with any certainty. However, the IA simply asserts that there are too many uncertainties to model meaningfully the impact of the proposals.

219. This is not a reasonable default answer in the context of proposals which are assumed to reduce the GDP costs of a future crisis by 25%. A full qualitative appraisal should still be undertaken, with a focus on identifying unintended consequences and assessing their likelihood. For example, possible unintended consequences resulting from responses of banks and market participants include:

- if there is opaque, discretionary and non-contractual bail-in, then this is likely to deter debt providers from lending to banks at risk except on a secured or short-term basis (and any secured or short-term lending may only be made if there is absolute clarity that this is outside the scope of any bail-in). If lenders are concerned about the risk of bail-in, lenders might withdraw funding from other banks as well as the bank under stress (particularly where the "trigger" points at which bail in may arise are opaque), which may lead to contagion;
- there may be little incentive for non ring-fenced operations in a ring-fenced bank to assist ring-fenced parts experiencing funding difficulties. Ring-fencing regimes "cut both ways", and arms' length contracts may prove less flexible in coping with stress.

220. These are, of course, a subset of the risks of unintended consequences.

ASSESSMENT OF THE RISKS AND UNINTENDED CONSEQUENCES

221. A number of risks have been considered in the IA[18], but the IA does not provide a complete assessment of a number of serious risks of undesirable, unintended consequences:

- The ring-fencing regime, additional loss absorbing capital and bail-in will reduce the competitiveness of large UK headquartered banks by raising their costs substantially, narrowing the range of services they can offer to consumers and SMEs and restricting innovation. In this regard, it is striking that the IA does not consider in detail:
    - the adverse effects that this will have on consumers and SMEs. These will be wide ranging, including both direct effects (due to the loss of choice of products which can be offered by a ring-fencing bank) but also indirect effects. For example, as regards indirect effects, apart from increasing operational costs, ring-fencing may also reduce ring-fenced banks'

[17] Parameters include (among other things): the source of the stress, the potential effects it will have on banks, the pathways through which these effects will influence the banks and other market participants, the behavioural responses of banks and market participants, and the resulting impact of the stress scenario on financial stability.
[18] For example, see paragraph 69 to 70, Annex A of the White Paper.

savings rates by reducing the investment opportunities open to ring-fenced banks;
  - the adverse effects this will have on the competitiveness of UK banks vis-à-vis 'passported banks' (which will include non-EEA headquartered banks that have one or more subsidiaries regulated in other EEA Member States) and the 'shadow' banking sector which will both have lower costs and greater ability to offer wider ranges of services. Moreover, this loss of competitiveness will incentivise retail banks to restructure themselves in order to lower their costs and extend the range of products and services they can sell – with moving their headquarters outside the UK being one solution. In addition, if investment banks are prohibited from taking on sophisticated retail customers, then these customers will have the option of securing services via intermediaries. These intermediaries may increase the risk of crises, fraud and money laundering. Apart from the direct harm to competition, GDP and UK tax revenues, these factors have the potential to increase materially the risk and costs of future banking crises.
  - The ramifications of imposing obligations on non-EEA banks operating in the UK are also not costed. The UK has obligations in respect of financial services under the WTO GATTS and neither the legality of what is proposed nor the retaliatory measures available to countries (whose banks would be unable to exercise their right to trade in the UK without substantial expense) have been considered or costed.
  - The same applies to proposals to restrict choice of law and to limit persons with whom ring-fenced bank can deal/incur significant exposures.
  - Observing that ring-fenced banks primarily compete with other UK banks and that non-UK banks will face higher regulatory standards[19] is simply ignoring the consequences outlined above.

222. Bail-in will inevitably increase the cost and appetite that debt providers have for providing non-secured, long term bank debt both (i) ex ante and (ii) in times of crisis:

- *ex ante*, bail-in increases debt risk and thus the cost of debt, thereby increasing the cost of capital (equity being more expensive than debt) and limiting the ability of banks to lend given their capital requirements. The IA worries that there might be "little market" for contractual bail-in instruments[20] (where investors have freely accepted the associated risks), whereas there is considerably greater risk of investors having even less appetite for such risks being imposed on them regardless of the contract terms which they have agreed. The greater the lack of clarity and transparency as regards the circumstances in which bail-in may be exercised, the greater these adverse ex ante effects will be as debt providers will naturally become progressively more risk averse;
- in the run up to a crisis, providers of 'non-preferred' debt finance (i.e. which is vulnerable to being subject to bail-in) will have strong incentives to withdraw such funding to banks or not renew it when it comes up for renewal. Lenders will do this well ahead of when they expect a "bail-in" trigger to be exercised, thereby potentially generating a wholly avoidable crisis as long term debt capital is withdrawn. This risks increasing instability in the financial sector in time of crisis by exacerbating funding crises;
- Depositor preference amounts to other creditors effectively paying for the UK bank deposit compensation regime in the event that a bank fails, rather than this scheme being funded by a levy across all banks. This does not make sense – there is no

[19] See paragraph 110, Annex A of the White Paper.
[20] See paragraph 3.44, Annex A of the White Paper.

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good reason for any category of creditors to be treated differently, with this being wholly contrary to longstanding UK legal principles. Depositors should be confident that they will not lose any money through the operation of a levy. The Government should be very wary of increasing the risks of other creditors as in a time of crisis they will be more likely to cease supplying essential goods and services to banks. For example, does the Government really wish to increase the risk of banks' IT systems etc failing during times of crisis as IT companies do not wish to be unpaid?

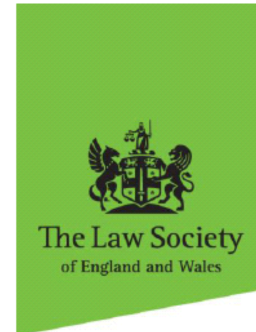
223. A comprehensive assessment of the risks and unintended consequences should be considered as part of the appraisal process. The IA should act as a risk management tool to assess and minimise exposure to these risks and unintended consequences.

ANNEX II: MEMBERSHIP OF THE LAW SOCIETY BANKING REFORM WORKING GROUP

Dorothy Livingston (Chair) – Herbert Smith LLP
Charles Morris – Clifford Chance LLP
Chris Moss – JMW LLP
Greg Olsen – Clifford Chance LLP
Jennifer Marshall – Allen & Overy LLP
Karen Anderson – Herbert Smith LLP
Mark Clough QC – Brodies LLP
Mat Hughes – Ashurst LLP
Michael McKee – DLA Piper LLP
Patrick Buckingham
Paul Feathers – Wragge & Co
Penny Sanders – Wragge & Co
Philip Wood QC – Allen & Overy LLP
Simon Currie – Covington and Burling LLP
Temi Akinrinade – Ashurst LLP

Tax questions answered by the Law Society Tax Law Committee

ANNEX III: LAW SOCIETY LETTER TO DG INTERNAL MARKET



Mr Hannes Huhtaniemi
DG Internal Market
Commission of the European Union
Brussels,
B-1000
Belgium

26 April 2012

Dear Mr Huhtaniemi,

Re: Working Document of the European Commission, DG Internal Market, on bail-in as a debt write-down tool

I am writing to you today in support of the Response to the working Document submitted by the City of London Law Society, on 20th April 2012. I write on behalf of the Law Society of England and Wales (EU Interest Representative Register ID: 38020227042-38).

The Law Society is the representative body of over 140,000 solicitors in England and Wales. The Society negotiates on behalf of the profession and makes representations to regulators and Government in both the domestic and European arena. This response has been prepared on behalf of the Law Society by members of our Working Party on Banking Reform. The working party is made up of senior and specialist lawyers and an economist, with expertise in banking and financial services regulation, competition law, EU law and international commercial law.

The Law Society of England and Wales supports the Commission's stated objective of ensuring that regulatory authorities in Member States have the necessary resolution tools to take effective action when banks get into financial difficulty and to help minimize disruption to markets and economies. We would welcome the development of mechanisms which achieve this aim and ensure the continuity of essential financial services for consumers and businesses.

Accordingly, we appreciate the publication of the Commission's discussion document on the appropriate rules for the operation of bail-in as a mechanism for enhancing stability in the financial system.

The Law Society has not prepared a full response to this discussion document. Instead, we are writing in support of the response submitted by the City of London Law Society (CLLS). In this response paper, the CLLS raises a number of important points about the principles and practicalities of bail-in.

The Law Society of England and Wales concurs with the general view of the CLLS that the key guiding principles should be certainty and clarity in the law, together with the principle of freedom of contract[1]. The Law Society is of the view that any tool which may interfere with the ability of banks and their funders to agree the terms on which they deal requires the strictest safeguards and protections, so that (i) investors and counterparties cannot be taken by surprise, (ii) funding is correctly priced and (iii) the rule of law is effectively respected. Thus if the regulatory aim is that a certain percentage of a bank's liabilities should be capable of conversion into equity (subject to bail-in) in the event that the bank gets into financial difficulties, that bank should be free to achieve that target in a consensual matter, eg through defined securities issued, and/or defined deposits

[1] CLLS comments, paragraphs: 5, 68 and 69.

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accepted, on terms that allow for bail in. The regulatory aim should not be achieved by giving regulators powers of conversion over all the bank's liabilities subject to exceptions of uncertain scope.

In the light of these more general comments, we therefore agree with the CLLS suggestion that the range of liabilities which can be 'bail-inable' should be defined clearly and limited to suitable classes of liability, where the value of the liabilities can be readily ascertained. This more limited application of bail-in is to be preferred over a wide ranging approach covering all liabilities (with a limited number of exemptions). We take this view not only for the principled reasons set out above, but because of the impracticalities of having a wide-range of liabilities subject to 'bail-in'. We consider the CLLS response paper to make this point powerfully. A bail-in policy which is limited in its nature, and which is clear on the liabilities to which it applies, is far more workable and much less complex than a less discriminating approach. In particular the Law Society shares the views of the CLLS with regard to the list of liabilities set out in the CLLS response to Question 3 of the discussion document. We would respectfully urge the Commission to consider carefully the arguments made by the CLLS in relation to each of these liabilities.

The Law Society also supports the suggestion in the CLLS response that it must be clear from the outset whether a particular liability is likely to be subject to 'bail-in'. This clarity is in our view absolutely fundamental to the requisites of the principle of legal certainty. Liabilities subject to compulsory bail-in will be more risky than those which are not. The increased uncertainty associated with a bail-inable liability will increase the risk premium which all creditors require when they deal with banks. This will in turn lead to higher funding costs and reduce the competitiveness of affected banks and their groups, as compared with those whose principle operations are outside the EU. The costs of an over-inclusive approach will be borne by EU economies as the costs incurred by banks will feed through to customers. In addition, there is an increased risk funds will be less available generally, and in particular that the increasing reality of the risk of actual bail-in will lead to a flight of funding from any evidently weakening bank and precipitate an avoidable and unnecessary crisis with its accompanying loss of confidence for the whole banking sector.

In addition, the discussion document does not appear to give sufficient coverage to the danger that bail-in could lead to distortions in the market for bank debt. Bail-in could alter the relative prices of different kinds of liabilities and thus produce a disincentive to some institutions from making decisions which would otherwise be wholly appropriate. We take the view that the longer-term effects of bail-in should be examined more closely before any concrete proposals are put forward.

We share the view of the CLLS that any reforms need to be international, rather than simply confined to the EU. Some agreement under the auspices of the G20 (or similar) would ensure as level an international 'playing field' as is practical. As noted above, the introduction of bail-in could increase financing costs for banks. Increases in such costs would, over time, have an impact on their international competitiveness, and on consumers at home. In turn, this would be likely to have a negative effect on the long-term growth rate of the financial services sector, which would have a knock-on effect on growth rates in the EU. A consistent policy across the major advanced and emerging economies is therefore important. Such an approach would help minimise any potential negative impact, from the introduction of a bail-in scheme, on the business activities of Europe's international banks.

We also concur with the CLLS that a margin of discretion for the parties concerned is key when it comes to how banks meet their reserve requirements, and their ability to absorb losses in general. The Law Society considers that while regulators should set the minimum requirements in respect of banks' loss absorbing capacity, it should be up to the banks themselves to decide what mixture of tools is most appropriate for them (including potentially voluntary bail-in which would be agreed with those providing the bank debt in question). This view is slightly different from that taken by the CLLS in answer to Question 5(a) of the discussion document.

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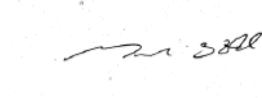
Although this letter is necessarily brief, I felt that it would be worthwhile taking the time to write to you in order to indicate the Law Society's support for the important points made by the CLLS and too emphasise the importance of considering fully the risks and costs of compulsory bail-in. Furthermore, the Law Society looks forward to contributing in greater detail, in the future, to the ongoing debate over banking reform.

Yours sincerely,



Mark Stobbs
Director of Legal Policy, The Law Society of England and Wales

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ANNEX IV: CLLS RESPONSE TO DG INTERNAL MARKET

The response can be accessed here:

http://www.citysolicitors.org.uk/FileServer.aspx?oID=1169&lID=0

A copy is also sent alongside this response.