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INDEPENDENT COMMISSION ON BANKING: CALL FOR EVIDENCE

Submission by the Building Societies Association

Executive Summary

- The BSA believes that reform of the banking sector in the UK is necessary to prevent dominant shareholder-owned banks benefitting from implicit Government guarantees that enable them to distort the markets in which they operate.

- The relationship between the Commission's objectives of promoting competition and financial stability is currently biased towards the latter, partly as a consequence of the remedial action taken by the authorities in the recent financial crisis. Reforms being considered by the Commission can be positive for both competition and stability. And a well-operating banking sector will support the Commission's secondary objectives of aiding a sustainable economic recovery and the UK's competitive position.

- The regulatory changes already due to be introduced in the UK are likely to impose a considerable burden on firms, and potentially a disproportionate burden on financial institutions that are primarily retail funded, and to smaller firms generally. Whatever reforms are recommended, the Commission should carefully consider how best to introduce the reforms and how to manage the transition.

- The Commission should take steps to improve sustainable competition. These should include requiring the largest systemic banks to divest assets, beyond those already required by the European Commission, and a limit on market share that constrains growth by acquisition, similar to that in the Dodd-Frank Act in the USA. The aim should be a diverse set of providers in terms of size, scope and ownership structure.

- Promoting diversity of ownership structures within the financial services sector benefits both competition and stability, and should be encouraged by the Commission. As well as delivering greater stability by way of alternative strategies and lower risk business models, relative to plc banks, a strong mutual sector also results in heightened competition, accountability to consumers, higher levels of customer satisfaction and trust, and a focus on long-term relationships.

- As well as lowering the probability and impact of failure, structural reforms are also likely to be necessary to prevent systemically important firms from discounting the potential costs of their activities to society. These are likely to include structure related surcharges, greater use of contingent capital and mechanisms to improve the resolution of large, complex firms.

- Other reforms, while containing much merit, might be difficult to implement in practice, or are likely to have an unacceptable impact on the volume of long-term lending.

- Whatever reforms the Commission recommends, attention needs to be given to the potential transference of activity and risks to the shadow banking sector, and procedures might be provided for "bank-like" entities to be brought into the regulated sector in the future.

Introduction

1. The Building Societies Association (BSA) represents mutual lenders and deposit takers in the UK including all 49 UK building societies. Mutual lenders and deposit takers have total assets of over £365 billion and, together with their subsidiaries, hold residential mortgages of almost £235 billion, 19% of the total outstanding in the UK. They hold more than £245 billion of retail deposits, accounting for 21% of all such deposits in the UK. Mutual deposit takers account for about 36% of cash ISA balances. They employ approximately 50,000 full and part-time staff and operate through approximately 2,000 branches.

2. The BSA believes that reform of the UK banking sector is necessary. Risk and return have become divorced, most obviously in the largest plc banking groups that are so important to the stability of the financial system that they cannot be allowed to fail. This confers on them an implicit subsidy (made explicit in some cases in the passage of the financial crisis) as they are protected from the downside risks from their activities, which are then passed on to society. This distortion needs to be remedied.

3. The Issues Paper asks about the relationship between the Commission's two primary objectives of promoting competition and financial stability. Overall, the Commission must decide what it is trying to optimise, or whether some sort of second best solution, for example relying on capital buffers, is sufficient. Whatever objective is chosen, trade-offs must be addressed to achieve this. Practically, it is likely that some complex balance must be sought between conflicting objectives. The Commission will not (and nor should it aim to) remove all risk-taking by the banking sector. Over time, some firms will fail, and should be able to do so, albeit without detrimental effects to retail depositors, the wider sector, or society.

4. The BSA believes that competition has been sacrificed in the interests of financial stability in recent years, and that steps to improve sustainable competition in the market are of utmost importance. Promoting a diversity of providers in terms of organisational type and size can help to deliver both stability and competition. It is also likely to make sense that capital and liquidity requirements are greater in relation to the riskiness of the institution, and a greater use of debt instruments that are convertible to equity in a crisis are likely to be beneficial. Stability and competition require that firms can exit the market without harming the banking system or wider society, so the resolution of failing institutions will require greater transparency and well-constructed mechanisms.

5. Whatever outcome the Commission suggests, it needs to think strategically about what is likely to be the reaction of agents currently in the market and those that may enter. Any changes recommended by the Commission will result in shifts in the organisation of the banking sector. Some of these shifts will be foreseeable, some will not. Some will occur swiftly, others only gradually. In particular, any transference of activity to the shadow banking sector needs to be considered, and principles on how activities beyond the perimeter of the regulated banking sector should be monitored, and if necessary, brought into the regulated sector, should be set out.

6. The submission below responds to the questions raised in the Issues Paper, but deals with the four final questions by looking at the structural reform options in turn.

> **Question 1.1: What is the relationship between the Commission's two primary objectives of financial stability and competition (including consumer choice)? Are these goals fundamentally in harmony? If not, what are the tensions between them and how can reform proposals be designed to alleviate the tensions?**

7. The relationship between financial stability and competition is complex, but the BSA is strongly of the view that recent experience has shown that the goals of competition and financial stability are currently in disharmony. As the analysis in the Issues Paper shows, UK

banking markets are highly concentrated[1]. Financial markets were growing gradually more concentrated prior to the crisis, and steps taken during the crisis by the Authorities in the interests of financial stability have exacerbated this dramatically.

8. The problem of systemically important financial institutions (SIFIs, referred to elsewhere as too big or too important to fail) is identified by the Commission as fundamental to the incentive problems in the banking sector, and this has been exacerbated by the authorities' reactions to events of the last few years. For a prolonged period large banks have benefited from implicit (and in some cases in recent years, explicit) state support.

9. Systemic importance is dependent on the economic and financial context, as has been recognised by the FSA[2]. It can arise from a firm's size and scope, how inter-connected a firm is with other institutions or the markets generally, and also in the way that the market can perceive problems at one firm to be representative of all firms in a common group, such that the assessment of the group as a whole has systemic implications. However, this latter cause is especially dependent on market conditions, so is difficult to address directly without considerable unintended consequences.

10. However, it should be recognised that larger firms do not automatically lead to greater systemic risk. Larger institutions might be better able to cross-subsidise internal operations that are affected by events in different ways or at different times, than are smaller firms. For example, larger firms might benefit from the diversity of their business lines, and from not being concentrated in one geographical region or market segment. Again, this depends on the external shocks being faced and the prevailing market conditions.

11. Most of the measures taken to protect the financial system during the credit crunch served to strengthen the position of large incumbent firms. For example, the forced merger of HBOS with Lloyds and the capital injections into Lloyds Group and RBS both served to reinforce the dominance of the larger incumbents. As the Bank of England stated in its June 2010 Financial Stability Report,

> "Larger UK banks expanded much more rapidly than smaller institutions in the run-up to the crisis and have received disproportionate taxpayer support during this crisis. That reflected a misalignment of risks on TITF banks' balance sheets, due to implicit guarantees on their liabilities."

12. Andrew Haldane has claimed that 145 banks across the globe that had assets above $100 billion in 2008, accounting for 85% of the assets of the world's top 1000 banks, but these institutions received over 90% of the support offered by governments during the crisis[3].

13. More generally, increased and more intensive regulation, introduced in response to the crisis, tends to impose a greater proportionate cost to smaller firms than larger ones. It also adds to the barriers to entry, so may be expected to lead to the concentration of financial markets over time.

14. The arguments that the concentration of market power in a few institutions can benefit financial stability apply insofar that Government support for firms that are too-big-to-fail becomes inevitable (although it is notable that under the oligopolistic structure that has arisen in UK banking markets, competition, while unfair, has been intense). When one of these large institutions does run into problems they simply cannot be allowed to fail. This

[1] It is worth noting that Figure 7 in the Issues Paper states that Nationwide had an 18% share of gross lending in 2009. However, this is an overstatement because it is based on Nationwide's figure for gross lending in the year to 5 April 2009, while the majority of other banks have financial years ending 31 December 2009. This discrepancy arises because across the total market, gross lending fell 43% year on year, according to Bank of England data. According to data from the Bank of England, the whole building society sector had a 13% share of gross lending in 2009.
[2] See FSA Discussion Paper 09/04: http://www.fsa.gov.uk/pubs/discussion/dp09_04.pdf
[3] Haldane, A, 2010, Bank of England, 'The $100billion question'

was seen to be the case with RBS or HBOS (and subsequently Lloyds). This arrangement, however, has the result of subsidising the activities of institutions such as this, even under normal market conditions, allowing them to compete unfairly, potentially distorting competition.

15. Reforms being considered by the Commission can be positive for both competition and stability. However, there are factors that hinder the effective working of banking markets. These include severe information asymmetries and principal-agent problems, and the externalising of downside risks that distorts incentives. This is why the banking system has been subject to intensive regulation and Government intervention throughout history. Given these conditions, a market characterised by high levels of entry and exit may undermine consumer confidence in banking, to the detriment of stability. And because of their value to society, there are some activities where stability must trump competition, such as with regards to the provision of the payment system.

16. To alleviate the tensions between competition and stability, a number of reforms are necessary. The distortions to competition, such as implicit state support, need to be removed to break the trend of increasing concentration that is heading toward dominance by large plc banks. It will also be necessary to put in place mechanisms that allow firms' exit from the market, and these will be need to be shown to apply in practice when a firm fails in the future, with the potential for creditors and uninsured depositors to experience losses. Mechanisms should be put in place for regulators to react to cover shadow banking activity if it becomes "bank-like", in order to avoid risk and return becoming divorced. Structures and mechanisms to discipline the discretion of the regulators in terms of competition should also be considered (ie to avoid the behavioural risk of regulatory capture over time).

17. An extra reform that can help bring improvements in both competition and stability is the promotion of diversity in financial services provision in terms of size, scope of activities, type of firm and geographical dispersion. For example, one reason why, despite the increased concentration of market power, competition has remained intense is that the activities of other providers with different business models have imposed a competitive constraint on the large plc banks. Because they do not have to pay dividends, by maintaining efficient operations building societies and mutual banks are able to offer competitive interest rates on mortgage and savings products. As a result, mutuals have been found to provide the majority of consistently top-performing products[4]. Other recent research from the University of Oxford has highlighted that a diversity of ownership structures leads to greater competition, stating that "it is generally the case that you get more competition not just by adding more firms with the same business model but by also adding firms with different business models to those which are already there".[5]

18. As well as increased competition, diversity can help to deliver greater stability. For example, a stronger mutual sector would reduce herd effects in business strategy across the financial system as a whole because of its alternative governance structure to the plc form. While publicly quoted banks might be expected to try to maximise returns to shareholders, mutuals pursue alternative strategies that are a consequence of the customer being the primary stakeholder. In a speech in 2009, Andrew Haldane, Executive Director for Financial Stability at the Bank of England, highlighted the increased homogeneity of business strategies in the run up to the crisis as firms all tried to diversify, but in the same ways, which reduced rather than strengthened the resilience of the system as a whole[6]. This is a fallacy of composition in that what is good for an individual institution does not apply to all institutions together[7]. A strong mutual sector with different incentives to plcs can potentially reduce such system-wide herd effects, while the existence of a diverse set of institutions with

[4] For example, Moneyfacts press release, 19 January 2010 http://www.moneyfactsgroup.co.uk/press/pressreleases/displaypressrelease.asp?id=727
[5] Michie, J, 2010, Promoting Corporate Diversity in the Financial Services Sector http://www.kellogg.ox.ac.uk/researchcentres/documents/mutuals%20oxford%20brochure.pdf.
[6] Haldane, A, 2009, Bank of England, 'Credit is Trust'
[7] Michie, J *Ibid, 5*

differing scale and business strategies, as is the case in the mutual sector, benefits intra-sector competition and stability.

19. One reason for this increased stability is because mutuals tend to be more risk averse than shareholder-owned financial service providers, partly because it is more difficult for mutuals to raise external capital (apart from via retained profits). In addition, the majority of a mutual's members are savers, who are risk averse because they would not benefit from any upside, but could be subject to any downside from risky strategies. Mutuals have been less reliant on wholesale funding than plc banks, with more stable retail funds accounting for 70% or more of total funding. And lending has tended to be more responsible, with arrears lower than at many other lenders. Of course, mutual firms were not immune to the financial crisis, and a number had to be merged when they ran into problems. However, the mutual sector relied much less on direct Government support than did the banks.

20. The Commission also raises the issue of misaligned incentives between owners, creditors and managers. Andrew Haldane also stated that the mutual model "may do a better job of aligning stakeholder incentives than some alternative forms of corporate governance… Mutuality reduces the scope for misaligned incentives between shareholders and depositors which might otherwise arise in a joint stock bank"[8]. As democratic organisations, members of building societies can vote to appoint directors to the Board, so directing the strategy of the organisation. And mutuals have made considerable improvements to their corporate governance in recent years, with greater disclosure of information and considerable investments to increase the engagement of members[9].

21. Mutuals have also been shown deliver higher levels of customer service and trust, a result of a focus on the customer as the owner, the importance placed on long-term personal relationships, and the maintenance of a local branch network[10].

22. And mutual lenders and deposit takers of all sizes have their headquarters located throughout the United Kingdom, all outside the City of London. And they place great importance on close relationships with their local communities[11]. In this way they also add to the geographical diversity of the financial services sector.

23. It is also certainly the case that measures aimed at improving stability can negatively affect competition via poorly designed regulations (Paragraph 3.22 of the Issues Paper). A recent example that risks this detrimental outcome is the definition of capital, and the BSA has urged the Treasury to take a strong pro-mutual lead such that new Core Tier 1 instruments are available which meet regulatory and investor demands but which are also consistent with mutual ownership. In policy-making in general, the mutual form should not be considered inferior to, nor as an afterthought to, the plc model.

Question 1.2: What weight should the Commission give to the other objectives – on lending and the pace of economic recovery, competitiveness, and risks to the Government's fiscal position – in its analysis?

24. Over time, a well operating banking sector will help to achieve the other objectives of supporting a sustainable economic recovery and improving international competitiveness. Other analysis has shown the substantial benefit from financial stability on economic output in the medium to long-term[12]. As long as any lending that is prevented is unsustainable, it is beneficial if it is curtailed, although it might be difficult to identify such lending in advance of a downturn. And assessing the optimal extent to which lending for long-term projects should be reduced requires some assessment of the required level of long-term investment in

[8] Haldane, A, 2009, Bank of England 'Credit is Trust'
[9] http://www.bsa.org.uk/publications/industrypublications/conversations_with_members.htm
[10] Mutuals outperformed other banks across 11 service measures, see BSA 2010: http://www.bsa.org.uk/docs/consumerpdfs/customerservice.pdf
[11] BSA, 2009, http://www.bsa.org.uk/publications/industrypublications/communities_report.htm
[12] BIS: http://www.bis.org/publ/othp10.pdf

capital stock in the UK. So the Commission is correct to focus on competition and stability, but should consider the consequences of any recommendations on these other objectives.

25. A further objective that is not mentioned in the Issues Paper is one of distribution. For example, steps taken to improve financial stability or competition might lead to some households being excluded from banking services if these customers were less profitable to serve. The Commission should also consider if any of its recommendations cause the supply of financial services to be withdrawn from any market segments.

26. Overall, reform needs to be introduced in a proportionate manner, allowing sufficient time for transition to take place. It is not clear that this is the case with the regulatory reforms currently planned by the authorities (see answer to Q2.1 below). With the current heightened degree of risk aversion in the markets, however, there is unlikely to be an urgent need to introduce reforms rapidly.

Question 2.1: Are there other broad options for reform that should be added to this framework? For example, should any of the "other reform initiatives" listed in Paragraph 4.33 be matters on which the Commission should seek to make recommendations?

27. The BSA does not believe that there are other major options for reform that the Commission need consider beyond those listed. However, any changes recommended by the Commission need to be implemented carefully such that financial services providers are not unduly burdened with structural and regulatory change at a time when the business conditions are already extremely challenging, as they are in the current low interest rate environment. Already the other reform options (as listed in paragraph 4.33 of the Issues Paper) impose what may well be a prohibitive cost on existing firms. And it is important that the impacts of these other regulatory changes are considered in aggregate, rather than on an individual basis, in terms of their affordability for providers and their impact on the economy. The BSA welcomes the FSA's work with NIESR in attempting to model the impact of the capital and liquidity changes, while recognising the high level of uncertainty inherent in such models.

28. Building societies and mutuals are subject to a number of concurrent changes including increased capital and liquidity requirements, the Mortgage Market Review, the Building Societies Specialist Sourcebook, changes to the deposit guarantee scheme and the Bank Levy. Each of these on its own would cause substantially higher compliance costs in firms. One standout example is the proposed European Directive on deposit guarantee schemes which envisages the establishment of a fund in each member state equivalent to 1.5% of insured deposits within 10 years. This is likely to absorb much of building society profits for the next 10 years. This is an intolerable situation; it will mean that societies and other mutuals would be continuing to post-fund the consequences of the banking failures of 2008, while facing a massive bill to pre-fund the rescue of institutions failing in the next crisis. If there is any chance of a levy of this size being imposed on the building society and mutual sector as a result of the Directive, it is difficult to see how the mutual sector (or indeed many other financial service providers) in the UK could survive.

29. More generally, it is extremely frustrating for mutual lenders and deposit takers which generally pursued conservative business strategies in the run up to the crisis to be disproportionately affected by some of the proposed regulatory reforms. It has already been mentioned that increased regulation imposes a greater proportionate impact on smaller firms, while the costs of the Financial Services Compensation Scheme have fallen excessively on firms, such as building societies, that used more secure retail funding to fund their lending. Measures currently being introduced to create a more stable and competitive market are actually putting at risk a sector that is predominantly lower risk than shareholder-owned banks. In the future, it is vital that regulation is proportionate and considers the impact on firms with different business models.

Question 2.2: Which (if any) of the reform options identified in the above framework most deserve further development, specification and analysis?

30. Most of the reform options identified are not mutually exclusive, indeed some address different aspects in relation to stability and competition. And any one reform option alone is unlikely to resolve all the pertinent issues. Therefore, the Commission should investigate several of the options, but also how they might interact with each other as there may be trade offs between some of the potential reforms that need to be balanced.

31. Overall, given the high degree of market concentration, the BSA believes that options related to the structure of markets should be the primary area for further investigation. Even if none of the reforms relating to the structure of banks are pursued, it is surely necessary for the excessive market share of the very largest plc banks to be addressed, and for divestures of assets beyond those already required by the European Commission to be required of these institutions.

32. The BSA would support a similar measure in the UK to that in the Dodd-Frank Act in the USA whereby mergers and acquisitions are not permitted which would take the firm's share of total sector liabilities over a pre-defined threshold. Organic growth is permitted beyond this limit. For the atomised US market, this threshold is 10%, but the appropriate figure for the UK would require investigation, as it is likely to be higher in the UK, which has historically had a much less fragmented market. The appropriate figure might be as much as double the US threshold. Furthermore, it would make sense to allow the regulator to permit this threshold to be breached in the interests of financial stability at times of crisis.

33. Diversity of competitors' business models must be promoted in the future, and the Oxford research into this suggests a number of reforms to the regulatory structure to encourage regulators and policy makers to fully consider alternative business models[13]. Related to this, the BSA fully supports the Commission's call in October 2010 for the new Consumer Protection and Markets Authority to have a primary duty to promote effective competition (rather than simply to 'have regard'), and that HM Treasury should ensure that the importance of competition is reflected in the roles of the new financial regulators[14]. Within this, the importance of diversity of providers' business models should also be promoted by the new regulatory bodies[15].

34. Mutual lenders and deposit takers would welcome lower barriers to entry and expansion in retail banking, and we welcome the recent review by the OFT. This would be a worthwhile endeavour, even if the financial crisis had not occurred. However, experience suggests that it will be extremely difficult to reduce these barriers. Regulatory barriers have grown since the crisis, and the branch, staff and systems requirements to initiate a banking operation are considerable. And a major barrier is the establishment of trusted relationships, meaning much more than just a recognised brand. Trust is based on beliefs and perceptions, so takes a long time to develop. As such, the low level of switching may be viewed as a result of the importance of long-term relationships rather than entrapped consumers[16]. The OFT review found that low levels of switching, high levels of customer loyalty and a preference for providers with a branch network were the greatest barriers to building market share, so much so that they may deter entry. These barriers are all related to the development of trusted relationships.

35. The Issues Paper also states that incentives could be distorted by ill-informed choice by consumers. However, this might be more complicated to correct than simply by providing more information. This is because of the relatively low levels of financial capability that

[13] Michie, J, *Ibid, 5*

[14] http://bankingcommission.independent.gov.uk/bankingcommission/wp-content/uploads/2010/10/icb-press-release-5.doc

[15] See the BSA submission to the HM Treasury consultation on regulatory reform: http://www.bsa.org.uk/docs/policy/regulatory_reform/bsa_response_18.10.pdf

[16] For more information see the BSA's submission to the OFT inquiry into barriers to entry exit and expansion in banking: http://www.bsa.org.uk/docs/policy/OFT_B2Ebanking.pdf

persist in the UK today[17], and that mean that trusted relationships that are formed slowly and are based on experience and trial-and-error are fundamental to banking. Information should be clear, and procedures for switching straightforward, but the reliance on trusted relationships is likely to be a fundamental factor in explaining the inertia observed in consumers in financial markets.

> **Question 3.1: What would the benefits of these options be, in particular for financial stability and competition? How can these benefits be quantified?**
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> **Question 3.2: What would the likely costs be of the various options? For example, what lost efficiencies might there be if banks were required to reduce the range of activities they could undertake, and/or their size? How can these costs be quantified?**
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> **Question 3.3: What are the implications of the role of the (less regulated) shadow banking sector for the Commission's work? To what extent would the different reform options simply shift problems from the banking sector to the shadow banking sector?**
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> **Question 3.4: Should any of the broad options be ruled out as impractical? If so, why?**

36. The reform options relating to the structure of banks are addressed below, taking into account Questions 3.1 to 3.4. Unfortunately, the costs and benefits of the various options are extremely difficult to quantify. Structural changes alone will not prevent future financial crises, and some behavioural regulation will always be necessary.

37. The shadow banking sector will need monitoring so that entities are regulated (or not) based on their economic substance rather than their legal form. An example is those money market funds where investors' capital is guaranteed to be returned, virtually on demand. Such funds were not regulated like banks, but in this form, they should be, or required to convert to variable value funds that do not offer liquidity on demand, as called for by Paul Tucker[18]. Several of the reform options could result in a shift of activities and risk to the unregulated shadow banking sector. To the extent that the regulated sector relies on the shadow bank sector for funding, say, this could in fact hide the true risks posed by the regulated sector. And the shift to the shadow sector could be so substantial that the Government and regulators cannot ignore large firms in these sectors in case they run into problems. The authorities must therefore be vigilant to risks arising in the shadow banking sector, and be prepared to take action if entities' economic substance makes them appear very close to regulated firms, even if they are legally separate. This is particularly the case as there are bound to be unintended consequences of any reforms the Commission suggests.

Separation of retail and investment banking

38. Although the impact of the crisis was not limited to banks with universal business models, separating retail and investment banking has the advantage that investment banking activities are not undertaken with retail deposits which have received an implicit state guarantee, so that risk-taking is not subsidised by the public, nor by other less risky deposit takers via the deposit guarantee scheme. This functional separation allows the most valuable services to the public to be protected. However, by itself this reform doesn't prevent the mismanagement that can occur even at simple firms, such as occurred at Northern Rock, for example. There are also likely to be practical problems introducing such reforms in the global financial markets, including the potential impact on the City, but the costs of the recent financial crisis to the UK economy mean that this reform should not be rejected out of hand.

[17] FSA, 2006, Financial Capability in the UK: Establishing a baseline
[18] Tucker, P, 2010, Bank of England 'Shadow banking, financing markets and financial stability'

Narrow banking and limited purpose banking

39. Narrow banking where retail deposits are 100% backed by Government bonds would result in the isolation of transaction services and deposit taking to ensure their safety. However, this raises a number of problems that make such an extreme restructuring undesirable. Firstly, this would substantially reduce the amount of funds available to lend to productive long-term projects. Secondly, although deposits would be completely protected, it is likely that more risky lending would shift into the shadow banking sectors to such an extent that these entities would require regulating to ensure the stability of the financial system as a whole. Thirdly, narrow banks may be so narrow that they in fact become higher risk because of the mono-line nature of their activities: they become positively correlated such that some shock, such as a sovereign debt crisis, affects them all in the same way. Narrow banking may not therefore lead to greater financial stability overall. Finally, at currently prevailing yields on government debt, there would probably be insufficient return on the bank's assets to make the business viable.

40. Under limited purpose banking all financial intermediation is conducted by mutual funds, so lending is completely backed by owners of shares in the mutual funds. But there may not be sufficient private sector short-term liabilities to cater for the demand for liquid short-term savings. Many households would be likely to prefer more liquid deposits, while many others would not want the risk that their investments could fall in value so their only option would be to invest in cash mutual funds. And maturity transformation is an activity that produces socially useful results. As with narrow banking, long term projects may struggle to attract funding. Limited purpose banking would probably result in a substantial reduction in lending, and therefore reduce economic activity.

Limits on proprietary trading and investing

41. Where proprietary trading occurs that takes advantage of the public subsidy arising from firms being too-big-to-fail, it seems appropriate that limitations are applied. But the practical limitation identified by the Commission of distinguishing between propriety trading and risk-reducing hedging might be difficult to overcome, and the American experience of introducing the "Volcker Rule" has shown the difficulties of introducing such reform in practice.

42. Building societies have relatively narrow banking models, with the Building Societies Act limiting the proportion of wholesale funding to a maximum of 50% and requiring at least 75% of loans to be secured on residential property, and restricting the powers of a building society in relation to trading or acting as a market-maker in securities, commodities or currencies, and entering into transactions involving derivatives, except for the purposes of hedging risks. These limits, and the difficulties mutuals face in raising new capital, have helped to constrain risk-taking by building societies.

Structural separability, including living wills and resolution schemes

43. An increased degree of separation may be a more practicable solution compared to those considered above. In particular, separately capitalised and regulated subsidiaries with a common holding company might be beneficial because by increasing transparency it limits contagion across business lines and aids structural separability in the event of a crisis. Dealings between subsidiaries would be on an arm's length basis, and additional reporting could improve transparency. This would need to apply to subsidiaries of large firms that are different in terms of economic substance. However, for regulatory purposes, it may be necessary to view the firms at a group level, as the crisis showed that many supposedly separate vehicles were actually dependent on the commercial bank (and vice versa). However, requiring separately capitalised institutions might raise entry barriers to different markets, and so reduce competition.

44. Rather than separate operating units, structural separability refers to ability to divide systemically important banks into their separate operating functions should circumstances require. However, this might be difficult to achieve, and designs that are separable *ex ante*

might prove too interconnected when problems arise. A threshold in terms of complexity or scope of operations might be used to determine which institutions would need to develop such plans in detail.

45. Living wills are proposed as a means of committing firms to how their assets and operations would be split in the event of a crisis, enabling the regulator to assess the extent to which these firms can be resolved. It would be necessary for these to apply only to complex, large firms. There would be little benefit, and considerable cost in terms of time and effort, for institutions and regulators to draw up such plans for simple, single purpose financial institutions. However, it might be beneficial for firms of all sizes to be encouraged to regularly consider how they would be wound up should such circumstances arise, as this might be helpful as a management tool to identify risks to the business.

46. Financial institutions are likely to require special resolution because they cannot be wound down in the same way as other businesses. Under the Banking Act 2009, a Special Resolution Regime was introduced to the UK, which reduces the need for living wills at non-systemic firms, although currently there is provision to require all firms to produce living wills in the future. Such a resolution regime can be used to speedily protect customer liabilities, which could otherwise result in knock-on effects to wider society. This regime was used in 2009 when the Dunfermline Building Society experienced losses on its commercial loans. However, it remains to be seen exactly how the failure of a larger, more interconnected, institution would be dealt with under the Special Resolution Regime. A highly interconnected firm still might not be allowed to fail because of the potential for contagion or wider economic damage in a protracted and complex resolution, particularly if the bank were operating globally. This therefore highlights the fundamental need to resolve the too-interconnected-to-fail problem, rather than relying on any resolution regime that can be tested only in practice once the institution is unable to continue as a going concern.

Contingent capital

47. A further measure that becomes applicable when a firm finds itself in difficulty is an alteration in the institution's capital structure, for example, as affected by the use of convertible bonds. A number of firms have already issued convertible contingent capital that would switch from debt to equity should a predefined threshold be breached. For example, when it merged with Chelsea Building Society in 2010, Yorkshire Building Society issued contingent notes that would convert into equity-equivalent instruments should Yorkshire's Core Tier 1 capital drop below 5%.

48. Contingent capital risks raising the cost of funding if bond investors demand higher premiums. With increased capital requirements (see below), the trigger threshold for contingent capital might be required to rise, for them to be useful to an institution. However, if the threshold rises, it might be more difficult to attract investors (ie. the demand from investors for contingent debt is likely to exist as long as the conversion is not expected to be triggered). There is also a potential signalling problem if conversion is ever triggered, as this would be viewed as an indication of the parlous state of an institution, such that confidence of other creditors, and depositors, could be damaged. It may, therefore, be difficult to attract demand from traditional investors for contingent instruments if they are too much like equity for fixed-income investors, and too much like bonds for equity investors.

49. Rather than the institution determining the threshold at which the debt converts, under a "bail-in" regime the regulator would decide when creditor claims (not just pre-defined convertible debt) should be partly converted to equity and losses written off. This would impose losses on creditors while the bank was still a going concern. As the regulators decide when conversion takes place, the bank's behaviour will not be influenced by the existence of pre-set triggers, as could be the case under contingent debt. However, such policies would alter the incentives facing creditors, for example by shortening the maturity of debt so that exit for creditors was easier, which could reduce stability. Whether the regulator should disclose which instruments are eligible for bail-in (and at what ratios) would need to be explored, as would ways to ensure that systemic firms held enough of such instruments that could be converted to recapitalise the firm to the regulator's satisfaction. Despite its

theoretical appeal, further investigation is needed into the possible problems and unintended consequences of introducing bail-in in practice. For example, if bail-in were to apply to all firms, it would raise the cost of senior debt to smaller and more simple firms, with little benefit to stability.

50. The BSA supports the proposal that institutions whose size and structure makes them systemically important should have a certain proportion of contingent capital. This should prevent their creditors pricing-in too much of a subsidy for (implicit) state backing. However, this should not apply to relatively small or simple firms, as it would raise their costs for little benefit. The Basel Committee has proposed that all non Core Tier 1 and Tier 2 capital instruments would have the contingency to convert or face write-down if a bank fails, but this requirement is likely to be excessive for non-systemic firms.

Structure-related surcharges

51. It is widely accepted that financial institutions will be required to hold higher levels of capital and liquidity in the future. In the UK the FSA has already required firms to increase the amount and quality of their capital and liquidity, and the Basel 3 requirements will augment and systematise this, and also introduce an overarching leverage ratio. The proposed regulatory changes in the UK will result in additional requirements for firms. The Financial Policy Committee will take counter-cyclical measures that aim to address system-wide risks via tools such as capital requirements, and the new regulator is also likely to impose more stringent requirements on systemically important financial institutions. Increasing these buffers will bring incentives at large banks closer to those required by society. And it is right that the surcharges are weighted according to the risk of a firm's business model, so that institutions that have structures and business models that are relatively simple and pose less of a risk to the system as a whole are less encumbered.

52. However, surcharges on capital, for example, may incentivise firms to make changes to their organisational structure, so the Commission should consider the interaction with any other structural reforms it may recommend.

53. By themselves such surcharges are unlikely to be sufficient, because over time they are likely to be circumvented, particularly by the movement of activities off balance sheet into the shadow banking sector. The Commission might wish to investigate whether the new regulator's discretion is sufficient to maintain such surcharges over time, or whether rules would help to prevent regulatory capture, though this might make the surcharges easier to circumvent. Work planned by the Basel Committee on additional capacity for loss absorbing at global systemic firms might help to prevent capture, as these requirements are to be applied internationally.

Conclusions

54. The BSA considers reform of the UK banking sector to be essential. In particular, the unfair competitive advantage of the largest plc banking groups that enjoy implicit and explicit state backing should be addressed. This has been exacerbated by the actions of the authorities in the recent financial crisis to try to stabilise the financial system. Divestures of assets by the largest banks are required, and other reforms are likely to be necessary to prevent these distortions arising in the future, such as a limit on the market share of institutions as in the Dodd Frank Act in the USA, though the appropriate limit in the UK may well be higher.

55. The recent crisis has shown stability and competition to be in conflict, but with reform this needn't be the case. The BSA would welcome lower barriers to entry and expansion into banking, although this might be difficult to achieve in practice. A further development that can benefit both of these objectives is by promoting a diversity of providers in terms of ownership structure and size. Mutuals have different incentives and have tended to be more risk averse than shareholder-owned banks. As a result, the mutual sector relied much less on direct Government support than did the banks through the crisis.

56. Preventing institutions from being subsidised by the public may also require surcharges related to firms' riskiness and systemic importance, and contingent capital to provide systemic firms with a buffer. And firms should be able to exit the market – for systemic firms this may require structural separability, or other mechanisms, such as living wills.

57. Whatever reform is recommended, considerable attention should be paid to the potential consequences, including the migration of activities and risks to other entities beyond the regulated banking sector. To the extent that these institutions behave like banks, such as constant value mutual funds, they should be brought into the regulated sector.

58. By ensuring that those that enjoy the returns of risk-taking also bear the potential downsides of their activities, the public is relieved of guaranteeing those firms which provide the banking services on which society depends, guarantees which distort competition even out of times of crisis.

November 2010