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"Report from the Independent Commission on Banking"

OXONIA Distinguished Speaker Event

By Sir John Vickers (Warden, All Souls College)

Oxford, 25 October 2011

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Sir John Vickers described the process of the Independent Commission on Banking (ICB), laid out clearly the package of reforms that the commission reported to the Government in September, and provided insight into the reasoning behind their recommendations.

The creation of the ICB was announced by George Osborne on 16th June 2010. The context was a UK economy still suffering from the impacts of the 2008 financial crisis, which had revealed a highly interconnected financial system in which systemically important banks were huge and unable to withstand severe economic shocks. As a result, the UK Government was forced to provide unprecedented levels of support, and even in spite of this, there has been a lasting negative effect on economic growth. With this in mind, the commission was specifically asked to recommend measures to promote stability and competition in the financial sector for the benefit of consumers and businesses.

Chaired by Sir John, the other members of the ICB were Clare Spottiswoode, Martin Taylor, Bill Winters and Martin Wolf. Sir John admitted that it was with some trepidation that these five independent thinkers came together, but he revealed that the process turned out to be "good fun". The larger team included support by fourteen officials, and there were numerous consultations with banks, the public and industry experts in order to gather information and ideas.

The first of two key recommendations to promote stability is 'ring-fencing' retail banking from investment banking. Sir John pointed out three benefits of a ring-fence. Firstly, it helps insulate retail banking services to individuals and small businesses, for whom the continuity of service is vital, from global financial shocks. Secondly, it would assist an easier and less costly resolution when banks fail, reducing the burden on taxpayers. Thirdly, it means retail banking can be made safer without impeding the competitiveness of investment banking for which international standards will still apply.

Sir John went into some more detail about this proposed structural reform. Two lines have been drawn to distinguish between services that are mandated, permitted and prohibited to be in the ringfence. The implication is that at least 18% of a universal bank's services will have to be inside the ring-fence. Ambiguity remains as to how banks will decide where to place the services permitted to be in or out of the ring-fence, such as deposits of non-EEA customers. A ring-fenced bank should be able to stand alone. If it is a subsidiary it is essential that the permitted extent of its relationship with other parts of the organisation should be no larger than regulators generally allow with third parties. The commission recommends that a ring fenced entity has a separate board with a majority of independent directors.

Regulation will be needed to ensure strong independent governance of the ring-fenced bank. It would be easier with a full break up, but Sir John and the commission do not go as far as recommending that. On the one hand they are restricted from doing so by current EU law and the risk of damaging UK competitiveness since international agreements place less stringent requirements on banks in other countries. On the other hand, sustaining some connection between the two arms of a bank means that the investment branch could potentially save a failing retail bank.

The commission wanted to address, too, the thin layer of capital and poor loss absorbing capacity exposed by the financial crisis. They have suggested, among other things, raising capital requirements, and introducing bail-in powers and a leverage backstop. It is hoped that these will reduce the extent of solvency, liquidity and deleverage risks that banks face when there is an economic shock. Raising capital requirements is costly (estimated £4bn - £7bn for banks and up to £3bn, or around 0.2% of GDP, for the economy) but the benefits are considered to be overwhelming: it reduces likelihood of financial crisis, the improved stability is good for investment, and it removes some distorted incentives to take on risk.

Sir John acknowledged that the 2019 deadline to implement the proposed stability measures was generous, but he made it clear that the commission did not feel arm twisted into the long timeline. He believes that it is a sensible date for completion as it allows time for adjustment, and matches the deadline for BASEL III requirements.

There was limited time at the end of the seminar for Sir John to discuss competition, which the final ICB report considers in much more depth. Briefly, the ICB recommends introducing a strong and effective challenger to create pressure to offer better rates, making it easier to compare and switch banks to assist the demand side's ability to create competitive pressure, and putting competition at the heart of regulation.

SIr John's final comments concerned the widening macroeconomic and sovereign debt crises, which he argues are no reason to avoid banking reform but in fact reinforce the need for a stable banking system. We have until the end of the year to wait for the Government position to be made clear. Lets see if they follow Sir John's advice of not letting 'too-big-to-fail' become 'too-delicate-to-reform'.

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