



Interim Report

**A short summary of our Consultation
on Reform Options**

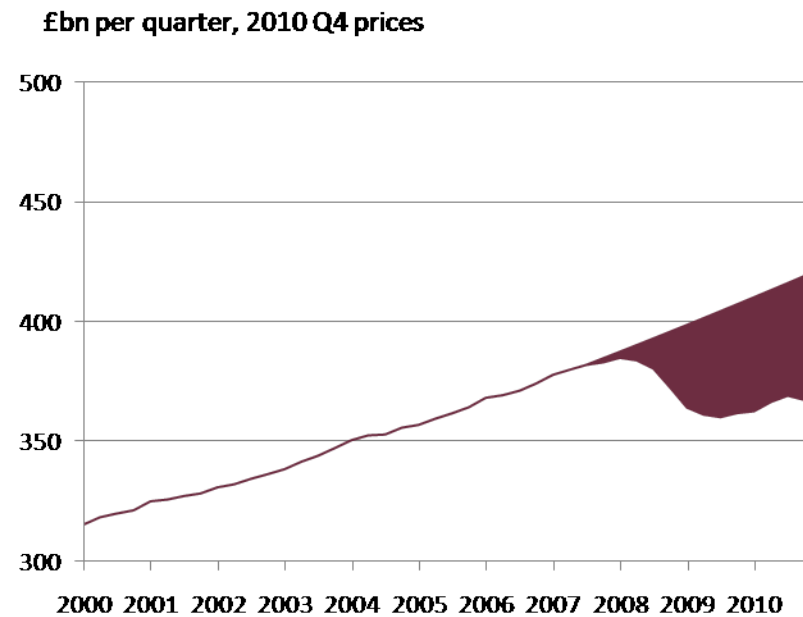
April 2011

The crisis had enormous costs: lost output, unemployment and weakened public finances – it also harmed banking competition

CONTEXT

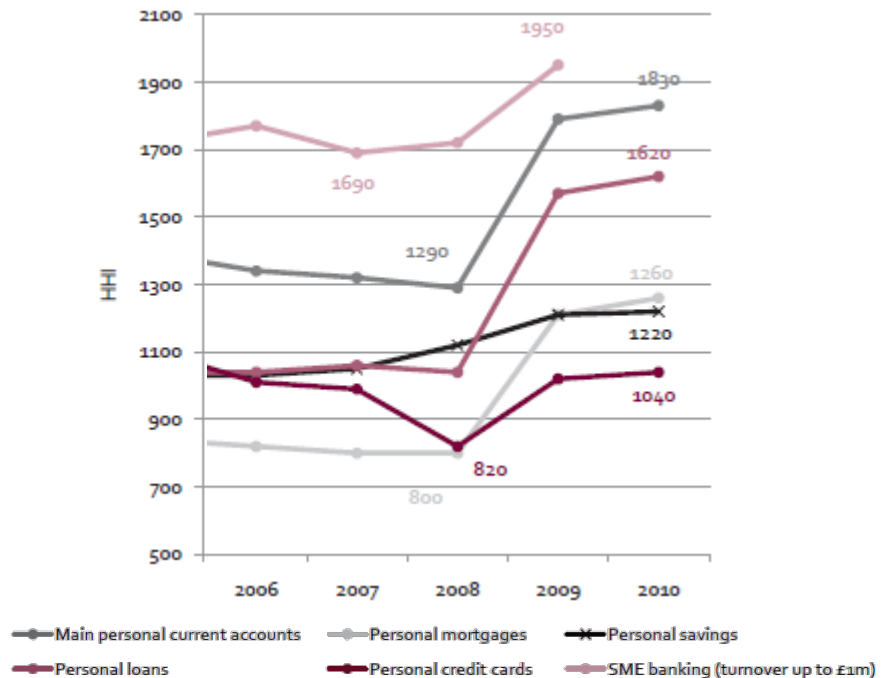
Weakened economy

The output loss relating to the crisis (shaded) is worth £400bn in today’s money. It could be worth £3tn if the output loss is permanent



Weakened competition

Concentration level in personal and SME banking measured using the Herfindahl-Hirshman Index (HHI)



The Interim Report aims to further the debate on how to make the UK banking system more stable and more competitive

GOALS

Improving stability

- Need combined approach that:
 - makes the banking system better able to absorb losses;
 - makes it easier and less costly to sort out banks that still get into trouble; and
 - curbs incentives for excessive risk-taking
- Banks ought to face market discipline – the implicit government guarantee of at least £10bn per year must be curtailed to prevent excessive risk taking
- It is important that we do this now – the next time, banks may be ‘too big to save’
 - despite recent de-leveraging, the total balance sheet of UK banks is still more than four times UK GDP

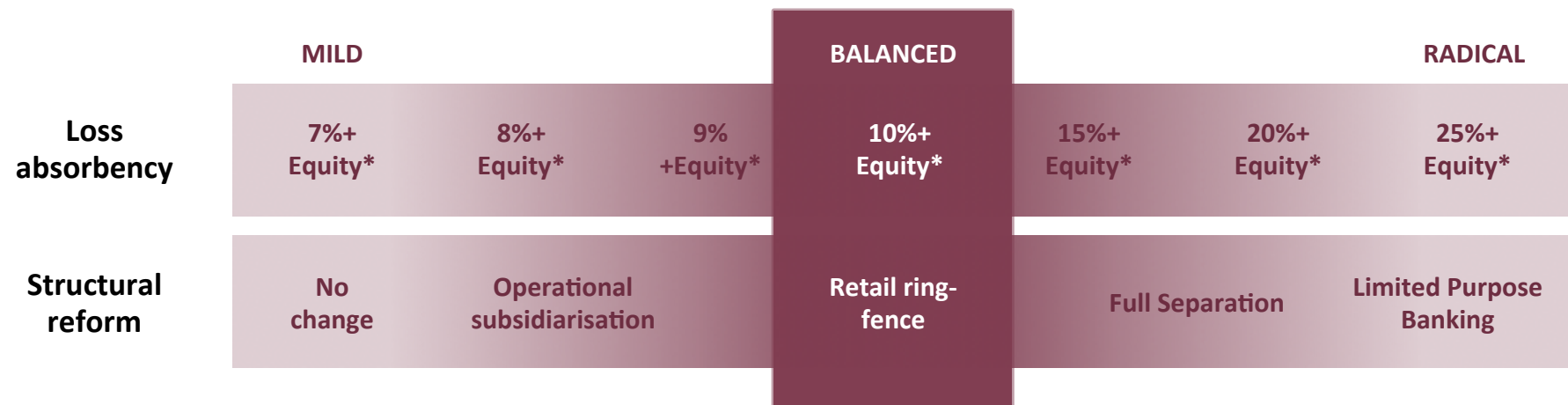
Increasing competition

- Competition in the banking sector can be increased through measures including:
 - the creation of credible challenger banks in the more concentrated retail banking markets;
 - an improved switching process; and
 - lower barriers to entry;
- Giving the new Financial Conduct Authority a primary duty to promote effective competition should assist in ensuring positive competitive outcomes on an ongoing basis

The best way to achieve our stability aims could be to combine moderate measures on loss-absorbency and structure

A BALANCED POLICY COMBINATION

- We believe the best way to achieve these aims could be to combine moderate measures on loss-absorbency and structure, rather than taking extreme measures on one front alone:
 - Systemically important banks must hold at least 10% equity against their risk-weighted assets, as well as loss-absorbing debt – although if international consensus does not reach 10%, wholesale & investment banks with loss-absorbing debt, which can fail without risk to the taxpayer, should only be required to meet internationally-agreed capital standards; and
 - UK retail banking activities should be ring-fenced to shield them from risks arising elsewhere within the bank or wider system



* Assumes banks also have loss-absorbing debt

The best way to achieve our stability aims could be to combine moderate measures on loss-absorbency and structure

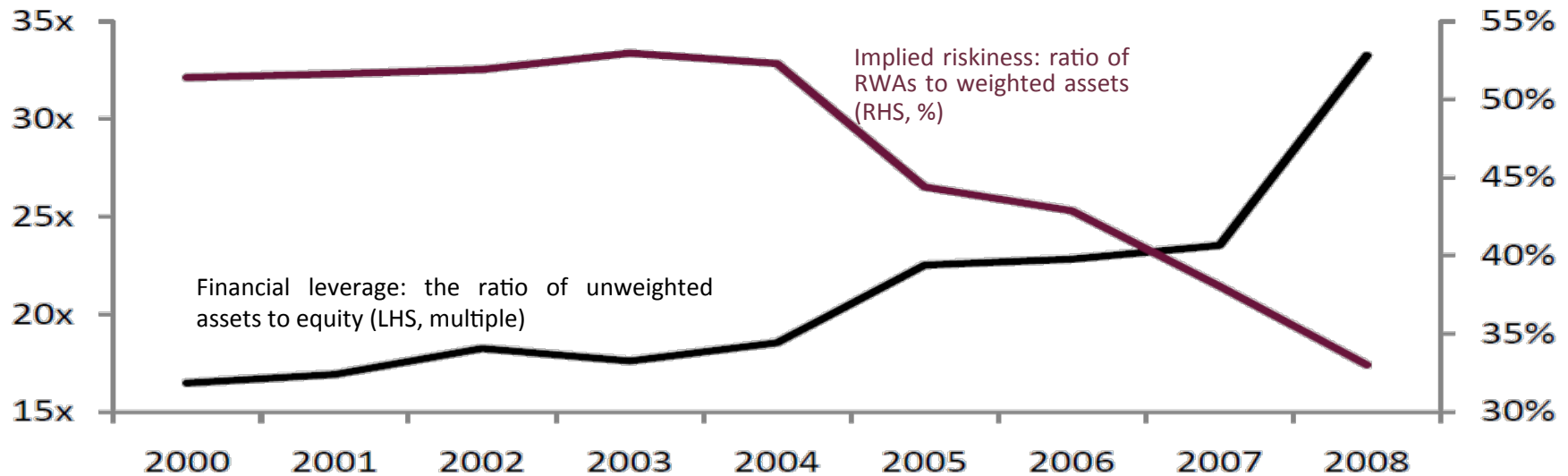
A BALANCED POLICY COMBINATION

		Structural reform	
		Mild	Radical
Loss absorbency	Mild	Fails to solve stability problem	Taxpayer on the hook for UK retail banking?
	Radical	Fails to shield retail banking from risks elsewhere?	Goes further than needed, real risk of geographical arbitrage

More loss-absorbing capacity would discipline banks and limit fallout from failure

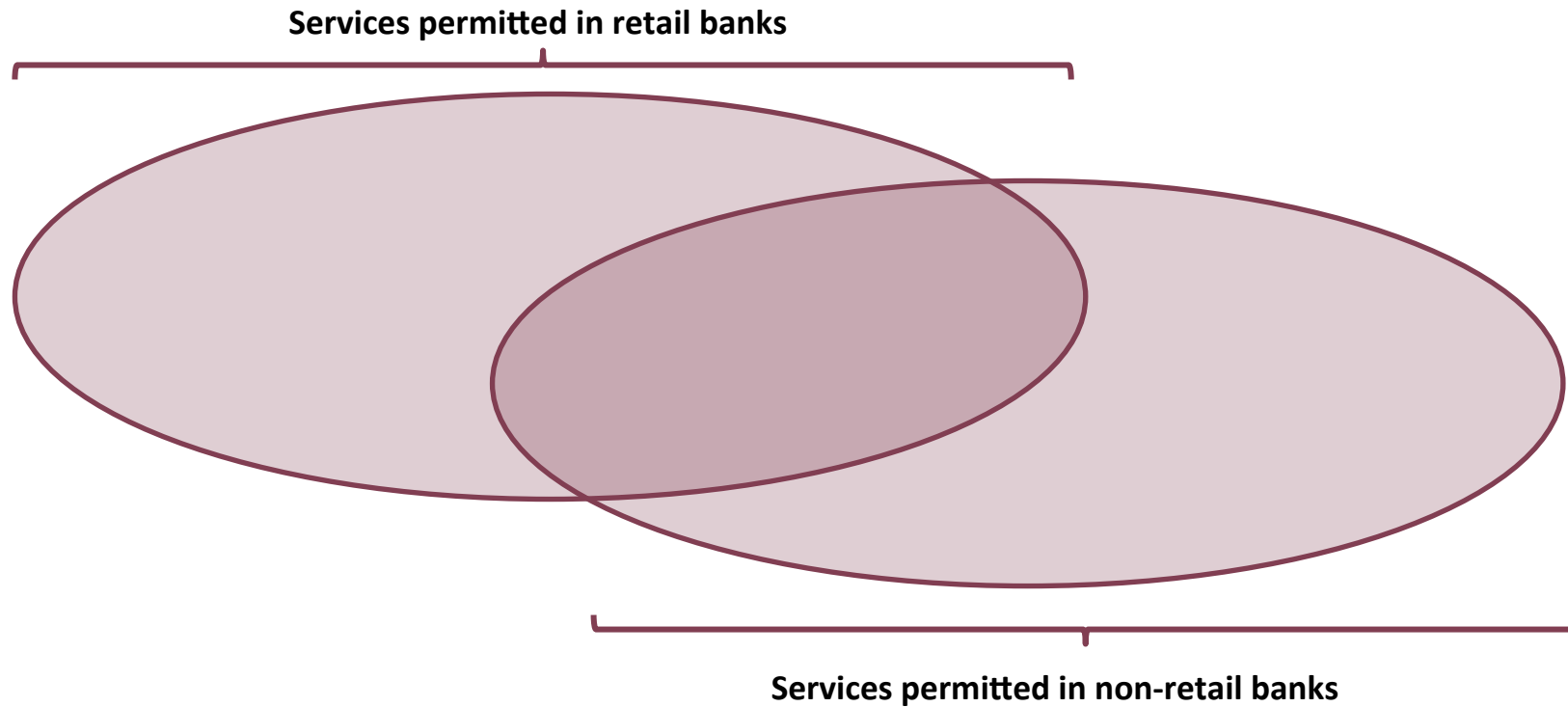
LOSS ABSORBENCY

- The risk-weights that underpinned the capital requirements of previous Basel Capital Accord have done a poor job
- Banks that are systemically important should have much greater loss-absorbing capacity, perhaps including:
 - at least 10% equity (on a Basel III basis); and
 - effectively loss-absorbing debt, such as contingent capital and bail-inable debt
 - depositor preference



Retail customers have few alternatives to banks for vital services, so retail services must be isolated from risk elsewhere

RETAIL RING-FENCE



* Retail deposits could include any deposits from persons who would be eligible for FSCS protection, or be limited to insured deposits only.

** Except where these involve retail deposit-taking, for example in the case of personal current accounts.

Our stability work will benefit competition – but further action is necessary to remedy the weak competition in UK retail banking

COMPETITION PROPOSALS

Substantially enhance the Lloyds divestment

- Lloyds currently has around 30% of current accounts in the UK
- It is required to divest a package of assets and liabilities to satisfy conditions for state aid approval set by the European Commission
- This divestiture will have a limited effect on competition unless it is substantially enhanced

Reduce barriers to entry and to switching

- Competition among incumbent banks, and between them and challengers, is blunted by the actual and perceived difficulties of account switching, and barriers to entry
- It may be possible to introduce greatly improved means of switching at reasonable cost, in which case the industry should be required to do this within a short timescale; this, in conjunction with other measures would assist in reducing barriers to entry in the retail banking market.

An FCA with a clear pro-competitive duty

- The Financial Conduct Authority proposed as part of the Government’s reforms of the regulatory architecture is potentially a vital spur to competition
- The Authority will have regulatory tools not available to the general competition and consumer authorities and should have a clear primary duty to promote effective competition

These measures would affect a small proportion of the City – and the stability they create should improve UK competitiveness

INTERNATIONAL COMPETITIVENESS

Table A8.1: Estimated employment shares of affected banks

Affected banks' share of wholesale financial services employment	Total estimate range (%)	Central estimation band (%)
Low estimate	7	14
High estimate	18	16

We estimate these measures would affect 14-16% of UK wholesale financial services employees ...

... 15% of UK wholesale financial services fees, and 7-11% of UK wholesale financial services earnings

Table A8.2: Affected banks' shares of all UK-based fees earned in wholesale financial services

	Affected banks' share of fees in loans, equity, bonds and M&A (%)	Affected banks' share of all earnings (all banks' share of revenues: 75%)	Affected banks' share of all earnings (all banks' share of revenues: 50%)
Low estimate	10	7	5
Central estimate	15	11	7
High estimate	25	18	12

Table A8.1 from Commission analysis
Data for Table A8.2 from Thomson Reuters, with Commission Analysis



Feedback welcome

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Consultation deadline

4th July 2011