Global Counsel

A very British split: the UK Banking Reform Bill

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Summary

This week the UK government has published draft legislation that will restructure British banks on significantly different terms than the rest of Europe and the US, and on terms that the government itself would not have chosen. For all the talk in continental Europe of its Anglo-Saxon intransigence and resistance to reform, the UK will probably be the only major jurisdiction to produce a serious structural reform response to the banking crisis. Why?

The British government has this week published the legislation that marks the final phase of a three year structural reform agenda for British banking. Although some important detail awaits secondary legislation, it is now certain that British banks will be required to ringfence and separately capitalise their retail operations, as Sir John Vickers' Independent Commission on Banking proposed in 2011. But the Bill also contains an escalator clause that would give British regulators the power to enforce full separation between a retail and an investment bank if they felt that the ringfence between the two was not being respected.

This marks a substantial victory for the cross-party Parliamentary Commission on Banking Standards (PCBS), which has spent the last three months reviewing the government's interpretation of the Vickers proposals. The Conservative Chancellor George Osborne initially resisted the idea of leaving the prospect of full separation on the table. This week he ultimately conceded that government would burn through precious political capital attempting to push the Banking Reform Bill through parliament without the PCBS' amendments.

It is not yet clear whether the powers to separate will apply to individual banks or to the sector as a whole – the Commission's own recommendation in this respect was ambiguous. The government has proposed the former, but the Labour opposition appears to have come out in defence of a threat left hanging over the sector as a whole – a sanction for misbehaviour so nuclear that it is hard to imagine any regulator ever using it.

The Brit split

This makes the UK the first and probably the only major banking jurisdiction to have responded to the banking crisis of 2008 by splitting retail and utility and investment banking operations in some way. The Belgian government has indicated that it favours a Vickers-style solution. The Netherlands is contemplating a variation on ringfence 'readiness' based on resolution plans and has launched a Commission under Herman Wijfels of Rabobank to consider other structural reforms. Shareholders may yet force universal banks to rethink some of their conglomerate structures, but the UK alone has actually pushed through a revision to the pre-2008 status quo by law.

So a few questions are worth asking here. The first is why the UK has ended up going so much further than the rest of the EU or the US on structural reform? The second is why the UK has opted for a form of structural reform that shies away from full separation while leaving the prospect of breaking up banks on the table. Both questions tell us something about the political economy of banking in the UK that matters.

Ironically given the Conservative government's tepid support for any kind of structural reform, the reason the UK has ended up with a substantial structural reform agenda owes a lot to the government's own political tactics. The incoming Conservative government in 2010 established the Vickers Commission as a concession to their Liberal Democrat coalition partners and to shut down the reform debate during the critical first year of its tenure. Given the consensus view that Britain's banks posed an existential risk to the UK economy, there was almost zero chance that Vickers would endorse the status quo, and he duly did not.

This decision to put structural reform on the table early has allowed the UK debate to run far ahead of the wider European regulatory process for banks. By the time Erkki Liikanen was asked to oversee a similar reflective exercise on structural reform at the European level in late 2011, European banks could already point to the rewriting of the Basel III standards and the European Commission's proposals for bank resolution as evidence that enough had been done to protect banks from failure and taxpayers from the failure of banks.

Paris and Berlin have both now proposed narrow prohibitions on proprietary trading on the model of the US Volcker rule as a way of heading off any temptation on the part of the European Commission to try and implement Liikkanen's proposed ringfencing of large trading operations which would have reshaped large French and German banks like Deutsche Bank and BNP Paribas. The European Commission has obligingly backed off. It may yet propose a European version of what Berlin has proposed, but it is as likely to propose nothing.

Does this divergence in approach to structural reform matter in competiveness terms for the UK? Obviously it imposes costs and constraints on the large UK banks that run UK retail arms that are not being incurred elsewhere in Europe. However these are spread over an implementation period between now and 2019. Any bank wanting to operate a retail operation in the UK will have to accept these structural constraints, so any wider competitive disadvantage will only be apparent once the costs of sustaining the ringfence itself and the higher capital requirements inside it are clear, and the implications of the costs of credit for non-ringfenced operations of UK banks are fully understood.

Culture and uncertainty

The second question is why the UK has ended up with a structural solution that both rejects the idea of breaking up universal banks, but leaves the prospect explicitly on the table. This is precisely the question that will hang over retail banks in the UK like HSBC, Barclays, Lloyds and RBS for the foreseeable future. The answer is in the way in which a debate about structure in banking in the UK has blurred into a debate about culture. Again this is not something that happened in the same way anywhere else in Europe. And again, events and the government's own tactics have played an important role.

Here the government's response to the LIBOR scandal and a string of mi-selling problems has decisively shaped the outcome. By setting up a Parliamentary Commission on culture in banking and asking the same Commission to assess the government's response to the Vickers recommendations, the government has invited UK parliamentarians to reframe the question set by Vickers from what makes a safe bank, to what makes a safe *banker*. The political answer implied by the industry's own conduct problems was: one with as little margin as possible to bend the rules now and in the future.

While Vickers looked at structural reform of banks chiefly from the point of view of systemic stability and the protection of the payments system, the MPs and Lords who have spent the last three months reviewing his conclusions consistently saw it as a cultural issue. They have probed witnesses on the supposed contamination effects of having retail and investment bankers working alongside each other within the same institution. The Banking Reform Bill they have shaped is the product of their clear view that the cultures of

retail and investment banking are fundamentally different and need to be quarantined.

The third question is obviously what the continued threat of full separation will mean for British retail banks and the companies that do business with them. The continued threat of regulator-imposed separation obviously creates an element of uncertainty for bank investors. But bank investors are already reassessing how they think about bank risk, and the rise of hybrid debt in bank capital cushions will in any case add a further dimension of uncertainty to investing in a bank. In waking up bank shareholders to the risks banks are taking, that is part of what it is intended to do.

As with bail-in and ‘coco’ contingent convertible hybrid debt, much comes down the precise triggers for regulatory intervention and the confidence of the regulator in using them. This legislation would turn the banks themselves into giant structural ‘cocos’ and put the onus on the regulator to pull an exceptionally serious trigger. The reality is that we simply do not know how this will work in practice. But given the scale of the potential sanction both banks and regulators are likely to collaborate in keeping the prospect well off the table.

Supporters of the escalator clause would say that is the point. Institutions that keep their noses clean have nothing to worry about. In this respect, raising the level of on-going scrutiny of the ringfence and the escalator approach has provided cover for both the government and the Parliamentary Commission to recommend that banks inside the ringfence should be able to sell simple derivatives products such as exchange and interest rate hedging products, something Vickers had excluded.

The British government has for a long time privately expressed a desire to achieve some closure in the banking debate. The Banking Reform Bill offers a prospect of that. Given the UK’s caricature in continental Europe for deregulatory zeal in the financial services sector there is a degree of irony in the fact that it has now gone further on structural reform since 2008 than its European peers have even contemplated. This outcome is the product of a debate in which politics has pushed the UK to move faster and more firmly than Brussels, and in which culture is as much of an issue as capital.

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