

4 October 2013

Sent via email:
banking.commission@hmtreasury.gsi.gov.uk.

Dear Sirs

Response to HM Treasury (the "Treasury") draft secondary legislation: Banking reform (the "Consultation")

The Loan Market Association ("LMA") welcomes the opportunity to provide a response to the Treasury in respect of the Consultation and hopes that its comments will be useful in the Treasury's upcoming review.

The LMA is the trade body for the European syndicated loan market and was founded in December 1996 by banks operating in that market. Its aim is to encourage liquidity in both the primary and secondary loan markets by promoting efficiency and transparency, as well as by developing standards of documentation and codes of market practice, which are widely used and adopted. Membership of the LMA currently stands at over 500 organisations from over 50 countries and consists of banks, non-bank investors, law firms, rating agencies and service providers. The LMA has gained substantial recognition in the market and has expanded its activities to include all aspects of the primary and secondary syndicated loan markets. It sees its overall mission as acting as the authoritative voice of the European loan market vis à vis lenders, borrowers, regulators and other interested parties.

The Consultation sets out the Treasury's proposals for draft secondary legislation relating to certain parts of The Financial Services (Banking Reform) Bill which was introduced to Parliament on 4 February 2013 with the aim of creating a stronger and more competitive banking sector. It is hoped that this will be achieved by increasing the sector's resilience to financial shocks, as well as by making banks more resolvable, so as to ensure that their failure does not threaten the provision of vital services to the real economy. With this in mind, we would like to respond to certain of the Consultation's questions which relate to the ring-fencing proposals, as well as provide some broad feedback relating to our views on the proposals generally.

Introduction

Whilst we understand the UK Government's desire to create a safe and stable UK banking sector, as an overarching point, we would wish to highlight that bank ring-fencing may result in certain unintended consequences for UK banking. Firstly, we would emphasise that any requirements imposed solely in relation to the UK banking sector could mean that it is put at a competitive disadvantage to the rest of Europe and other overseas jurisdictions or cause confusion with other similar regimes (e.g. those recommended in the EU by the Liikanen report). Secondly, there is a danger that, unless thought through in greater detail, the proposals will actually have a detrimental impact on SMEs, which are the very businesses that the Government is aiming to protect.

Above all, ring-fencing should not prevent banks from providing vital services to their customers. We would therefore suggest that greater flexibility is introduced with regards to the ancillary services

which a ring-fenced bank is able to offer individuals and SMEs, since too rigid a ring-fence will not only increase administrative and operational costs for the banks, but also create logistical challenges for borrowers themselves. We would also urge the Treasury to ensure that work is undertaken to provide clarity and certainty as to which services may, or may not, be provided by a ring-fenced bank, so as to prevent any confusion going forwards. This is likely to require in-depth consultation with both banks and borrowers in order to gain a complete understanding of which banking products are regularly provided to SMEs and the way in which they interact with each other to form a complete banking product package, all of which may be indispensable to a particular business. This is particularly important in the context of derivatives and trade finance products, which are specifically covered by the proposals (discussed further below).

By way of practical example of the importance of flexibility, the consultation discusses those situations whereby banks offer secured finance to corporate customers through conduit companies, accepting that a ring-fenced bank should be able to have exposures to such a conduit. However, the proposals qualify this by stating that this should only be allowed where the conduit exists solely to acquire assets from a single non-financial customer of the ring-fenced bank, and will use the assets as security for a loan from that ring-fenced bank. Whilst this exemption is certainly helpful in the context of the many loan facilities where funds are lent to SPV structures which are expressly set up to for the purposes of a particular customer (e.g. a real estate acquisition) we would query whether this covers off all relevant scenarios – for example, what if the conduit company is a joint venture which is jointly owned by two, or several, companies, rather than just one? Would it then fall outside the exemption on a technicality?

In responding to the Consultation, we have consulted with our members, particularly those banks who are likely to be most affected by the proposals arising out of this Consultation.

Consultation question 18: Will allowing ring-fenced banks to sell derivatives hedging interest rate, foreign exchange and commodity risk enable small businesses to hedge the most common risks?

Whilst we welcome the exemption for certain derivatives products, we would recommend that the Treasury continue to consult with both the banking industry and businesses on other derivatives products which potentially fall outside the proposed criteria – for example weather and inflation-linked derivatives which we understand are becoming increasingly commonplace, particularly for those borrowers involved in international trade. Prohibiting these products (or preventing new innovative products from being offered to its customers by ring-fenced banks) could result in these products becoming more difficult or costly to obtain.

Consultation question 26: Do you agree with the approach taken to banks' own risk management?

We note that under the original Treasury consultation to the Banking Reform White Paper, secondary market purchases of loans were expressly prohibited. In our response to this consultation, we argued that this was counter-intuitive since arguably, there is no difference between a ring-fenced bank lending to a corporate directly in the primary market and acquiring an interest in that same loan via the secondary market, as long as appropriate due diligence is conducted by the purchaser. We also argued that we could see no reason why secondary market loan purchases should expose the ring-fenced bank to additional risk or increase systemic risk within the banking system generally and that in addition, once the proposals were implemented, secondary loan purchases might be the only method by which a ring-fenced bank can lend to a large corporate – especially if the corporate's relationship is with a non-ring-fenced bank. Finally, we argued that one of the objectives of prudent portfolio management undertaken by a ring-fenced entity should be an ability to substitute risk weighted assets as and when required. Secondary loan purchases/sales are an important tool that permits this process to happen since if loan sales did not fall within the exemption, all loans entered

into by ring-fenced banks would become "loan to own" (unless subsequently securitised) – something which could prevent the bank from managing its portfolio effectively.

We are pleased to note that the express prohibition on secondary market purchases of loans has been removed. However, we note that is not an expressly permitted activity. We are of the opinion that secondary loan market sales should be an expressly permitted activity, especially given that ring-fenced banks will have the ability to securitise their own assets i.e. package cash flows from pools of assets originated on balance sheet into securities, which may be sold to investors (and arguably selling loan commitments via the secondary market is no different in terms of ultimate outcome).

Consultation question 29: Do you agree with the prohibition on ring-fenced banks having exposures to financial institutions?

We are of the opinion that the prohibition on all types of exposure to "relevant financial institutions" should be revisited for two reasons. Firstly, under the current proposals, lending to large corporates is not prohibited. Such corporates will have the opportunity to access either ring-fenced, or non-ring-fenced banks to fulfil their borrowing requirements. However, the provision of working capital finance to, for example, investment firms will presumably be prohibited under the current proposals since lending to this sort of entity is essentially an activity which creates a financial institution "exposure" for the ring-fenced bank. It is our view that a ring-fenced bank should be in a position to offer loans to both financial and non-financial corporates, especially since the liquidity coverage ratio (LCR) provisions of the Capital Requirements Regulation currently require that any facility granted to a "financial customer" is deemed to be 100% drawn, which would mean that the ring-fenced bank's systemic exposure to the financial institution is already arguably addressed through proposed liquidity regulation. Secondly, it seems at odds with the overarching aims of the legislation that lending to small banks potentially be permitted. There is nothing to prevent small banks undertaking risky investment strategies with the benefit of loans from ring-fenced banks (especially because they are not subject to the ring-fencing requirements and are therefore at liberty to undertake investment/wholesale banking activity). In addition, given that they will be trying to attract deposits from individuals and SMEs, by association, it is these types of depositor which will be most at risk.

Consultation question 33: Do you agree with the proposed exemption for exposures arising from the provision of payment services?

The information provided in 3.33 to 3.36 does not provide adequate information to enable consistent definition of which services typically provided by banks may be labelled as "payment services" and we suggest this section is expanded to improve the clarity around such services.

Consultation question 37: Do you agree with the proposed exemption for exposures arising from the provision of trade finance?

Whilst we welcome the exemption for certain trade finance services, we would recommend that the Treasury continue to consult with the banking industry on other trade finance products which potentially fall outside the proposed definition of "trade finance services" – for example performance bonds, letters of indemnity and the recently introduced bank payment obligation (BPO) product. Prohibiting these products (or preventing new financing solutions from being offered) could impact the very SMEs which the Government wishes to support. It is these sorts of arrangement which are essential to international trade should be offered by ring-fenced banks to their customers as part of their core banking services.

We therefore encourage the Treasury to continue to consult widely on these types of products, if necessary by initiating direct contact with trade finance divisions at UK banks, with a view to balancing potential systemic risk against the inherent advantages to borrowers of having direct access to such products.

Consultation question 45: (Geographical restrictions): Do you have any other views on the approach taken here?

We note that ring-fenced banks are essentially prohibited from providing services to customers outside the EEA. We would like to make two brief points:

Firstly, would this mean that ring-fenced banks are prohibited from confirming non-EEA letters of credit? For example, a SME that wishes to export its products abroad, may approach its bank to request an export confirmed letter of credit. An export confirmed letter of credit is a contractual commitment whereby the SME's bank commits to pay the SME on behalf of a buyer (located in a foreign jurisdiction) upon presentation by the SME of pre-agreed documentation (e.g. evidence of goods having been shipped). The bank will then send the documentation to the buyer's own bank (normally located in the buyer's jurisdiction) after which the SME's bank is reimbursed by the buyer's bank. Would this type of arrangement be caught by the geographical restrictions or would it constitute a service to the UK SME?

Secondly, it is feasible that a UK SME could have a small non-EEA subsidiary. If a loan is provided to the SME, would this prevent the ring-fenced bank from providing basic banking services to the non-EEA subsidiary?

Conclusion

Whilst targeted and proportionate legislation to guard against excessive risk in the banking sector is welcome, this must ultimately be balanced against the need to avoid unnecessary operational costs and inconvenience to bank customers, as well as to promote growth and ensure a healthy economic recovery. Much has been publicised in recent months about the need to stimulate the credit markets, and it is therefore vital that banks remain an important source of credit for the foreseeable future. If their activities become unduly constrained, or the logistical/administrative costs and operational difficulties of the reform become excessive, banks will be forced to shrink and delever, ultimately impacting their ability and their incentive to support their existing UK customers and provide much needed credit to the UK economy.

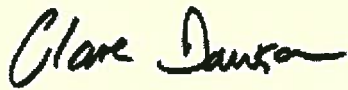
In addition, we would stress that any additional legislative measures adopted specifically in the UK are analysed closely with any that are agreed in Europe. There are two principle reasons for this. Firstly, the impact of all of these proposals on the industry is cumulative and they must therefore be considered as part of a "package" – too many individual pieces of regulation are likely to lead to confusion, and ultimately suffocation and disruption in the market and a reduction in the number of participants. Furthermore, the cumulative nature of the regulations could also choke off any chance of economic recovery. Secondly, it must be borne in mind that any requirements imposed solely in relation to the UK banking sector could put the UK at a competitive disadvantage to the rest of Europe in some areas.

Finally, we would emphasise that the proposals put forward by the Treasury under this Consultation will bring about fundamental and costly reforms to the banking sector, which, from an operational perspective, will be incredibly complex for banks to implement. Consequently, any legislation should only be implemented after very careful consideration. Whilst we appreciate the Government's desire to introduce measures which will prevent a future financial crisis, this should not stand in the way of a thorough and in-depth consultation of all relevant parties, at every stage of the legislative process. Not to do so simply risks an increased likelihood of unintended consequences arising, and the potential for increased disruption of vital banking services to customers.

We would be pleased to discuss any aspect of this response with you in more detail. If we can be of any further assistance, please do not hesitate to contact me via email at clare.dawson@lma.eu.com or

by telephone on 020 7006 2216. Alternatively my colleague Nicholas Voisey may be contacted by email at nicholas.voisey@lma.eu.com or by telephone on 020 7006 5364.

Yours faithfully

A handwritten signature in black ink, reading "Clare Dawson". The signature is written in a cursive, flowing style.

Clare Dawson
Managing Director
The Loan Market Association