Association of British Insurers

Risk, Reward and Responsibility: The Financial Sector and Society

The ABI's Response to HM Treasury Paper

Introduction

The ABI is the voice of the insurance and investment industry. Its members constitute over 90 per cent of the insurance market in the UK and 20 per cent across the EU. They control assets equivalent to a quarter of the UK's capital. They are the risk managers of the UK's economy and society. Through the ABI their voice is heard in Government and in public debate on insurance, savings, and investment matters. They welcome the opportunity to respond to this paper because of their substantial role as providers of debt and equity capital to banks.

At the core of their response is the belief that effective regulation and the effective application of competition rules could do much to alleviate systemic risk in banking. This would then render less compelling the case for loading additional taxes on to banks in ways that, especially if applied cumulatively, would almost certainly reduce their ability to extend credit at reasonable cost.

In particular ABI members question the feasibility of a tax on financial transactions, because of the risk that business would migrate to other centres where it was not imposed, the complexity of designing and implementing such a tax and the high administrative and compliance costs involved. As investors, ABI members are extremely sceptical of any substantial long term role for contingent capital instruments which, they fear, could exacerbate any future crisis.

General Comments

This paper addresses important issues. We need to make the financial system safer, while retaining its ability to innovate and allocate capital efficiently throughout our economy. However carefully we seek to strike this balance, we must recognise that periodically some banks will fail, and systemic risk cannot be eliminated entirely.

It is thus right to ask whether the risks and rewards are shared equitably, but the arguments need to be carefully considered and placed in a proper context, so that they are not just a short term reaction to the fact that share prices of banks have recently recovered while banks resumed paying large bonuses so soon after large scale government rescues.

It is not fair to presume that the taxpayer should bear no burden because all the rewards and none of the costs of failure go to banks and their owners. The imbalance is not as great as this argument assumes. Many bankers have rightly been fired for their part in the disaster, admittedly some with far too much reward for failure. Long term shareholders in banks continue to bear a burden because their shares have in no way returned to their pre-crisis levels, while they have contributed

billions of pounds in additional capital. Investors in the subordinated debt of banks have faced losses and uncertainty.

Meanwhile, taxpayers derive significant benefit from the contribution to economic growth of a well-functioning banking system. Their gross contribution to the bail-out has been large but the net ultimate cost to the taxpayer has yet to be calculated. According to the Chancellor of the Exchequer in his latest pre-budget speech, the long-run costs may turn out to be small or even non-existent as taxpayer contributions are refunded. The paper too acknowledges this point in paragraph 1.19.

The origins of the financial crisis are various. Short-termism and greed on the part of bankers and some shareholders played an important role, but a fundamental aspect was the failure of governments, elected by taxpayers, to address macro-imbalances and to contain the damaging surge in liquidity that resulted. Also regulators appointed by those governments failed massively in their task of prudential supervision. The collective nature of the responsibility implies that the burden must be borne collectively.

This is not therefore a question of shovelling costs from one party to another. Market discipline is important. Recognition by the private sector that losses are inevitable will stimulate good behaviour, but this must not be carried to the point where regulators and governments let themselves off the hook. A more constructive approach to the question of the balance of responsibilities is required to create confidence in a well-functioning banking system. Governments should work for a stable macro-economic environment; regulators should regulate banks better; bankers should manage risk properly and take a long-term view; and shareholders should become more effective in holding bank boards to account.

We are therefore wary of the idea that it is somehow possible to calculate the cost of systemic risk and pass it on to the banks. They should not have to pay an insurance premium in advance for the provision of liquidity at times of stress. The paper points out that regulators are tightening liquidity requirements on banks (paragraph 3.10) and that emergency liquidity already attracts penalty rates even with the provision of high quality collateral (paragraph 3.11). In other words, a high price is already built in to the provision of liquidity, and there should be no need for an additional charge.

Replacing present arrangements with an upfront charge as suggested in paragraph 3.15 poses a serious challenge because it would be almost impossible to calculate a reasonable level of fee. If the fee was too low, there is a risk that the authorities would fall foul of the EU state aid rules. If it was too high, banks would be penalised unfairly and this could have negative repercussions on their ability to lend. The advantage of existing arrangements is that the penalty costs of drawing on liquidity support fall on those who actually need it. An upfront charge would create a moral hazard problem because all would pay whether they needed it or not.

Conceptually a systemic risk levy makes somewhat more sense because it could be organised in a way that discouraged excessive risk taking. The Obama administration's proposals for what amounts to a tax on leverage could be a useful pointer, although this, too, could be made redundant by the subsequent proposed restrictions on banks undertaking proprietary trading, operating hedge funds and investing in private equity.

We also believe that any systemic levy should be globally applied and we are wary of the practical challenges. The paper itself notes (paragraph 3.40) that it would be extremely difficult to pitch a levy correctly and to calibrate it to reflect the relative level of systemic significance of individual institutions.

Moreover it could be difficult to ensure that any fund was actually used for the purposes set out and available when needed. The paper suggests that the proceeds could be used to pay down government debt or held in a separate fund which would invest in government securities. The accumulation of large funds could therefore simply lead governments to become less disciplined in their fiscal policy. One of the problems the UK has experienced in the crisis is that it came when the public finances were surprisingly weak given a long period of high economic growth.

More broadly it is much better to focus on building regulatory arrangements that limit the risks of systemic failure in the first place, as the G20 is now seeking to do. The paper notes that, prior to the crisis, bank capital was lower and trading risk greater than ever before, but it omits to ask why regulators, who have been inclined to blame banks and shareholders for doing nothing to stop this, failed to notice or react themselves.

We therefore agree with the objectives set out for the Government in paragraph 2.5, namely strengthening the institutional framework for financial stability, reducing the risk of firm failure, reducing the impact of firm failure where this does occur and enhancing regulatory focus on monitoring and mitigating systemic risk.

The critical factors in delivering these objectives are the quality of regulation and the ability of regulators to apply properly calibrated capital requirements. The paper rightly records progress in this area at the domestic and international level. These initiatives need to be pursued further.

Two further initiatives would help. First, there should be a fresh examination of the balance of fiscal incentives which may lead businesses to rely excessively on debt rather than equity financing. Though this is a complex area, we believe that an imbalance in favour of debt may have contributed to the crisis. Second, we believe the competition rules should be rigorously applied to banks; especially if it turns out they have indeed been making supernormal profits which have then been dissipated through payment of bonuses.

In our detailed comments below, we focus on two specific questions raised in the paper: the role of contingent capital and the possibility of a tax on financial transactions.

Contingent capital and capital insurance

We agree with the paper that banks need to hold sufficient loss absorbing capital. This will inevitably mean a strong increase in their Core Tier 1 equity, though this has to be phased in in a way that does not lead to diminished lending activity while the recovery is still fragile. We are less certain about whether the gap can be plugged in the longer term by the type of contingent capital instruments now being discussed.

These are essentially permanent interest bearing securities that convert into equity capital when a certain trigger point is reached. If the trigger is a defined share price,

this will be very visible to the markets and lead to intense and damaging speculative activity as the threshold is approached. This risk may be less if the trigger point is a defined level of Core Tier 1 equity since it will be less clear to the market that conversion is imminent. Indeed the speed with which banks can accumulate losses means that the market may have no inkling until the conversion point is reached.

However the risk of panic remains, especially if these instruments are widely held and carried in bond fund indices. Investors whose mandates require them to hold bonds and who cannot hold equities would be required to offload the securities at or before the point of conversion leading to massive forced sales in a highly illiquid market. This could exacerbate rather than reduce the presence of systemic risk.

Despite the short term success of the recent Lloyds Banking Group issue, it is not yet clear how much demand for this type of paper exists among long-term investors. Generally speaking, our members do not consider the paper suitable for matching annuity liabilities, which has hitherto been a principal reason for their involvement in the bank subordinated debt market.

If they are to encourage widespread use of these instruments the authorities therefore need to be sure that there is a stable long term demand for them among investors who understand and are prepared to deal with the consequences of forced conversion when it arises. It does not seem to us at present that these instruments are likely to form a major part of bank capital, though they may be useful during the transition to greater reliance on Core Tier 1 equity.

Capital insurance, whereby, in return for a premium, the insurer agrees to put in additional capital if trigger conditions arose, also poses some practical difficulties. One is that it would run contrary to the pre-emption principle whereby the right to subscribe to new equity is offered *pro rata* to existing holders. As with contingent capital there would be a threat of dilution. If the insurer did not want to be a long term holder of the shares, it is not clear who would own the new capital. Another problem is the difficulty pricing such insurance.

A private sector provider would have to face the possibility that claims would arise not just singly, when a particular bank needed a capital injection, but generally at times of systemic disturbance. Insurers would then face the risk of being swamped by claims, which might draw them in to the systemic crisis. Government providers would experience the same types of difficulty as that described above with regard to liquidity insurance.

Contingent capital and capital insurance thus seem to offer little by way of alternative to gradually increasing the reliance of banks on Core Tier 1 equity. Measures do, however, need to be taken to ensure that this does not permanently reduce the flow of credit to the economy.

The answer may be for the authorities to encourage sensible use of securitisation. Although the collapse in the market for securitised sub-prime mortgages sparked the onset of the financial crisis, securitisation has worked satisfactorily in the capital markets for many years. While some reforms have been introduced to address excess, this market should not be stifled altogether. It can still make an important contribution to the provision of credit provided we can avoid the pitfalls of excess leverage and the abusive use of special purpose vehicles.

Taxing financial transactions

The paper considers the case for introducing a tax on financial transactions from two perspectives. One purpose would be to raise additional revenue from the financial sector, the other to steer it away from risky or socially undesirable activities such as an over-reliance on short-term trading.

Whatever the motivation, the paper suggests (paragraph 4.17) that any transaction tax would have to be implemented globally. We agree with this, and we are sceptical of the subsequent assertion (paragraph 4.18) that this may be more feasible now than in the past given recent global success in co-ordinated clampdown on tax havens. The clear lack of support from the US for a transaction tax as expressed by treasury Secretary Timothy Geithner would be a significant handicap. Even if the US could be persuaded to change its approach, the prospects of reaching global agreement are daunting, given the complexity of financial markets, their ability to innovate to evade taxation and the difficulty of ensuring that all financial instruments are covered.

As to purpose, we do not believe that taxation should be used to micro-manage business models. It may be true that some banks and other financial market participants have become over-reliant on short term trading, but there is a large risk of unintended consequences – including a loss of liquidity in key markets - in introducing a tax on all transactions. Regulators can address activities deemed too risky or undesirable, either through the imposition of capital requirements or through outright bans of products that are clearly shown to be toxic. Such bans would probably be very rare, but a ban might have been worth considering in the case of credit default swaps when these gave the holder an active interest in the failure of the underlying company.

In parenthesis, we would note that the imposition of a transaction tax on all financial transactions would render the current application of stamp duty to share transactions even more questionable. One advantage of taxing all transactions might be that it would avoid the distortions that have seen a thriving market in contracts for difference(CfD) develop as the market sought to evade stamp duty. The lack of transparency in the CfD market has been a source of problems which are only now being corrected. On the other hand one would have to question whether similar unintended consequences would not also arise from an attempt to impose a general transaction tax.

Whether the banking sector should be especially subject to additional taxation is largely a matter for political judgement. The paper suggests (paragraph 4.2) this could be justified to ensure the sector makes a fair contribution to society and broader social objectives., but goes on to note both that the financial sector traditionally makes a large contribution to the exchequer, amounting to over £250bn in income tax and national insurance contributions in the last five years(paragraph 4.3). It warns (paragraph 4.24) that the incidence of tax should not in practice fall on end users of financial services within the economy at large.

It is difficult to see how this can be avoided. If the cost falls on shareholders, they will require a higher price for their capital which eventually will be felt in the cost of borrowing. Similarly, an increase in employment costs will eventually be passed on.

We therefore conclude that the existing policy, which is to treat banks and other financial sector companies in the same way as other businesses for tax purposes, is right, not least because it avoids economic distortions. We reaffirm the point made above that, if banks are making supernormal profits, then the right way to approach this is through robust application of the competition laws rather than through a discriminatory tax regime.