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Lords of the Ring-Fence: UK Banking Commission Publishes Its Final Report

"One ring-fence to rule them all and in the darkness bind them."

Admittedly, the above is not a direct quote from the final report of the UK's Independent Commission on Banking (the "Commission") published on 12 September 2011 (the "Report").[1] If implemented, the recommendations contained in the Report will, however, have a profound effect on the UK banking industry and the way it operates. The proposal that UK retail banking activities be carried out in a ring-fenced entity was the cornerstone to the interim report and has been preciously safeguarded by the Commission in its final recommendations. The Report has been described in some quarters as likely to prompt the biggest shake-up in UK banking in a generation. We summarise below the principal recommendations of the Report and provide some thoughts as to the impact the proposals will have if implemented.

The Commission was established by the UK government in June 2010 under the Chairmanship of Sir John Vickers and published its interim report in April 2011.[2] The first part of the Report deals with the Commission's recommendations for financial stability, which is divided into two main elements: (i) the proposals for a retail ring-fence for UK banking operations and (ii) measures it believes should be put in place to improve the loss-absorbency of UK banks. The second part deals with competition issues affecting UK banking markets. This alert focuses primarily on the Commission's recommendations in relation to financial stability.

Overview of Key Recommendations

Key recommendations of the Commission include:

- Establishment of a retail ring-fence for UK banks. Banks providing "mandated services" in the UK, including the provision of deposits and overdrafts to individuals and SMEs will be required to separate such activities into a distinct subsidiary.
- UK ring-fenced banks will be prohibited from certain activities and services including providing services to customers outside the EEA or which result in exposure to a non-ring-fenced bank or other financial entity.

[1] Independent Commission on Banking, Final Report – Recommendations, http://bankingcommission.s3.amazonaws.com/wp-content/uploads/2010/07/ICB-Final-Report.pdf.
[2] Interim Report, Consultation on Reform Options, http://s3-eu-west-1.amazonaws.com/htcdn/Interim-Report-110411.pdf. See also our client alert: ICB Interim Report on UK Banking Reform, http://www.mofo.com/files/Uploads/Images/110429-ICB-Report-UK-Banking-Reform.pdf.

- Where a ring-fenced bank is part of a wider corporate group, its relationship with other entities in the group should be conducted on an arm's length basis and its solvency or liquidity should not be dependent upon the continued health of the rest of the group.
- Large UK retail ring-fenced banks should each be subject to an equity buffer of at least 3% of risk weighted assets ("rwas") in excess of the Basel III minimum capital requirement of 7%. A sliding scale applies for smaller banks.
- In accordance with Basel III, UK headquartered banks and ring-fenced banks each should each maintain a leverage ratio of tier 1 capital to gross assets of at least 3%. Large UK ring-fenced banks should be subject to an increased leverage ratio of at least 4.06% (and there should be a sliding scale for smaller banks).
- The UK special resolution regime should be supplemented by a primary bail-in power enabling the authorities to impose losses on all unsecured debt of a bank with a term of at least 12 months at the time of issue. The authorities should also have a secondary bail-in power to impose losses on other unsecured liabilities of the bank.
- Deposits having the benefit of a guarantee from the Financial Services Compensation Scheme ("FSCS") should have priority over other unsecured creditors of the bank.
- Large ring-fenced banks or global systemically important banks ("g-sibs") headquartered in the UK should have primary loss-absorbing capacity of at least 17% of rwas. Supervisors should be able to raise this to 20% in certain cases where they believe the resolvability of the bank may be complex.

Financial Stability

The Commission states that its proposals in relation to the retail ring-fence and ensuring banks can better absorb losses, are connected to the "too big to fail" problem with large banks, meaning that governments are prepared to use public funds to bail out failing banks rather than allowing them to fail. It believes the combination of simplifying and limiting financial links between banks and making them more resilient will limit the spread of contagion throughout the UK banking system in the event of the failure of a bank and reduce the likelihood of such failure triggering a system-wide financial crisis.

Retail Ring-Fence

The Commission confirms its support for the proposal in its interim report that there should be a degree of structural separation between retail and wholesale investment banks in the UK but continues to resist calls for a total separation of retail and investment banking services. It provides further details on how it sees the ring-fence operating in practice. In formulating its detailed proposals for which services should (or should not) be included within the ring-fence and how high the ring-fence should be built in terms of legal, operational, and economic links permitted between ring-fenced activities and those of the wider group, the Commission has set out five principles:

Principle 1. Services that Must Be Provided by Ring-Fenced Banks. The Commission believes that only ring-fenced banks should be authorised in the UK to provide "mandated services" which it defines generically to cover services where even a temporary interruption to the provision of services resulting from the failure of a bank has significant economic costs and customers are not well equipped to plan for such an interruption. It believes such services currently comprise providing deposits and overdrafts to individuals and SMEs. It does, however, envisage that sophisticated high net worth individuals should be permitted to place deposits outside of ring-fenced banks in the UK subject to certain safeguards. Although the UK is not permitted under EU law to impose such restrictions on branches of banks authorised elsewhere in the EEA, the Commission believes the provision of mandated services in the UK by large banks based outside the EEA should be required to be carried out through a UK subsidiary that would be subject to the ring-fence requirement.

Principle 2. Services that are Prohibited from Being Provided by Ring-Fenced Banks. The Commission recommends that ring-fenced banks should be prohibited from providing certain specified services including those that make it significantly harder and/or more costly to resolve the ring-fenced bank or directly increase its exposure to global markets. The Commission believes prohibited services should include services to customers outside the EEA (including it would seem the provision of deposits to any person outside the EEA), activities which result in an exposure to a non-ring-fenced bank or financial entity (including insurance companies, pension funds, hedge funds and other investment funds) and services which would result in a requirement to hold regulatory capital against market risk. It believes this would mean the majority of the retail and commercial banking divisions of current UK banks could be included within ring-fenced banks but that the wholesale/investment banking divisions could not.

Principle 3. Ancillary Activities. The Commission acknowledges that there are a number of ancillary activities (that would otherwise be treated as prohibited services) that ring-fenced banks need to undertake to effectively provide mandated or other permitted services. It is envisaged that such activities will include ownership or procurement of necessary operational infrastructure, and risk management (including hedging) and liquidity management. Although the Commission recognises that wholesale funding from sources other than individuals and SMEs is an important part of a bank's treasury function, it states that over-reliance on short-term wholesale funding quickened the failures of a number of UK banks during the financial crisis and arguably caused some of them. Whilst it notes that properly controlled wholesale funding can improve the diversity of a ring-fenced bank's funding base, it recommends that backstop limits should be placed on the amount of such wholesale funding and on its total exposures (both secured and unsecured) to non-ring-fenced banks and other non-bank financial entities. It notes that building societies in the UK are currently subject to a cap of 50% in respect of such funding but states that a cap at this level may not be appropriate for all ring-fenced banks.

Principle 4. Legal and Operational Links. With the aim of enabling the authorities, where necessary, to isolate the ring-fenced entity from the rest of the group in a matter of days and continue the provision of its services without providing solvency support, the Commission believes that ring-fenced banks should be separate legal entities and should not be entitled to own any entity other than those conducting activities permitted within ring-fenced banks. It states that the wider corporate group should be required to put in place arrangements to ensure that the ring-fenced bank has continuous access to all of the operations, staff, data, and services required to continue its activities irrespective of the financial health of the rest of the group and it should either be a direct member of all of the payment services it uses or should use another ring-fenced bank as an agent.

Principle 5. Economic Links. The Commission states that where a ring-fenced bank is part of a wider corporate group, its relationships with entities in that group should be conducted on a third party basis and it should not be dependent for its solvency or liquidity on the continued financial health of the rest of the corporate group. This should be ensured through both regulation and sufficiently independent governance, with the board of the ring-fenced bank being independent. It sets out certain principles it believes should apply in ensuring this principle is met including (a) all transactions with other parts of the group (including asset sales to and from other group entities) should be conducted on a commercial and arm's length basis, (b) the ring-fenced bank should meet regulatory requirements, including those for capital, large exposures, liquidity and funding, and (c) dividend payments and other capital transfers should only be made after the board of the ring-fenced bank is satisfied that it has sufficient financial resources to do so. The Commission believes the ring-fenced bank should be prevented from providing any form of unlimited guarantee, indemnity, or similar commitment to the rest of the group and should generally not be party to agreements which contain cross-default clauses or similar arrangements which are triggered by the default of entities in the rest of the corporate group.

Required, Permitted, and Prohibited Activities of UK Retail Ring-Fenced Banks:

MUST PROVIDE	MAY PROVIDE	MUST NOT PROVIDE
• Taking deposits from and providing overdrafts to individuals and SMEs in the UK	• Taking deposits from and providing payments services to any customer within the EEA, including current accounts, savings accounts, and investment product which do not give rise to the bank being required to hold regulatory capital against market risk • The following kinds of services to individuals and non-financial companies of any size in the EEA: • secured and unsecured lending to individuals and businesses • credit cards • trade finance • project finance • advising on and selling products from a non-ring-fenced bank (provided no exposure to the ring-fenced bank)	• Any services outside the EEA • Services to financial institutions other than payment services and deposit taking • Services to any customer of the following kinds: • structuring, arranging, or executing derivatives transactions, as agent or principal • investing in stock, corporate debt securities, or convertible/exchangeable bonds • originating, trading, lending, or making markets in securities (but may originate and retain portions of own-label securitisations) • underwriting or placing sale of debt and equity securities

Analysis of Ring-Fence Proposals

It is no surprise that the Commission has maintained its view that UK banks should be subject to a ring-fence in relation to their retail activities. In some respects, in giving ring-fenced banks the ability to carry on activities such as commercial lending and trade and project finance and allowing activities such as hedging, provided they are ancillary to permitted activities, ring-fenced banks have more flexibility in their business activities than many feared would be the case. The list of prohibited activities will however, impinge on the provision of some permitted activities. The intention of the Committee seems to be that activities within the ring-fence should be primarily domestic UK activities. However, to avoid the recommendations breaching EU law, ring-fenced banks will be able to provide permitted services to customers within the EEA. No services (including, it seems, the provision of deposits) may be provided to any customer located outside the EEA, which includes jurisdictions such as Switzerland and the US. Therefore, to the extent a banking group wishes to include activities such as trade finance or project finance within the retail ring-fence, such services will only be able to be provided within the EEA.

In relation to the “height” of the ring-fence, the proposals are somewhat more restrictive than many were expecting. The Committee’s arm’s length term requirement in respect of activities between the ring-fenced entity and other members of the group will prevent any flow of capital from the ring-fenced entity to the rest of the group unless on fully commercial terms. There seems no reason in principle, however, why entities in the group which are outside the ring-fence could not inject equity capital into the ring-fenced entity. Maintaining a banking group with a ring-fenced entity is, however, clearly going to give rise to significant costs and administrative challenges.

It will be interesting to see the effect the proposals have on the way that ring-fenced banks fund themselves in practice. The Commission accepts that retail ring-fenced banks will be able to have some access to the wholesale funding markets although they do not give any firm guidance as to the level at which this should be capped. There also seems to be an acceptance that banks should be able to continue to fund themselves, at least in part, through the securitisation and covered bond markets although this is barely mentioned in the report and is therefore likely to be an area to be discussed in more detail as legislation is proposed.

There are also likely to be concerns as to the competitiveness of ring-fenced banks particularly in relation to branches of other European banks that could operate in the UK. As a matter of EU law, banks established in other EEA member states can passport activities into the UK, including retail deposit-taking, and would not be subject to any UK retail ring-fence unless it is imposed generally throughout the EU or by their home jurisdiction. It is unclear at present as to whether other jurisdictions in the EU will follow the UK's lead. Although branches of European banks do not currently provide meaningful competition in the domestic UK banking market, it is possible that could change in the future. The Commission also acknowledges the possibility of UK banks relocating their activities outside the UK, although it is not apparent that any are seriously considering such a move at present.

Loss-Absorbency

As part of its aim to make banks less likely to fail and better able to cope with losses up to the point of failure and ensure that shareholders and creditors, rather than taxpayers, suffer the brunt of losses in a failing institution, the Commission considers the amount of equity banks should be required to issue and, in relation to debt issued by a bank, how it can be made more loss-absorbent. The Commission also considers the total amount of loss-absorbing capacity that banks should be required to have.

Amount of Equity to be Issued by Banks. As stated in its interim report, the Commission notes that equity is by far the best form of loss-absorbing capacity and the amount of common equity issued by banks needs to increase significantly from current requirements. In this regard, it notes the Basel III proposals of the Basel Committee for Banking Supervision ("BCBS") provide for a bank's common equity to be a minimum of 7% of its rwas and that, in relation to g-sibs, the BCBS is recommending that they be subject to an additional common equity surcharge of between 1 and 2.5% (potentially rising to 3.5%) of rwas. The Commission maintains the conclusion reached in its interim report that large UK ring-fenced banks should be required to have an equity ring-fence buffer of at least 3% of rwas in excess of the Basel III baseline of 7% (i.e., at least 10% in aggregate). For the purposes of the Report, a bank is considered large if its rwas amount to at least 3% of UK GDP. Banks whose rwas to UK GDP ratio is between 1 and 3% should be subject to an equity ring-fence buffer of between 0 and 3% on a sliding scale. The Commission also maintains its view that to allow the wholesale/investment banking operations of UK banks to compete in global financial markets, they should not be subject to higher minimum equity requirements than agreed internationally provided such banks have credible resolution plans, including in relation to loss-absorbing debt.

The Commission believes that the equity ring-fence buffer should be in addition to the 7% minimum common equity ratio under Basel III and any further counter-cyclical buffer imposed under Basel III. In view of the fact that the rationale for the ring-fence buffer overlaps to some extent with the rationale for the surcharge for g-sibs referred to above, the Commission concludes the two buffers should not be additive and it is only the higher of the two that should be applied.

Leverage Ratio. The Commission strongly supports the use of a leverage ratio to supplement minimum capital levels based on rwas (which it is concerned incentivises banks to manipulate the risk-weighting of assets). It notes that Basel III provides a minimum leverage ratio of 3% of tier 1 capital to gross assets, to be effective from 2018 and recommends that all UK-headquartered banks should be required to operate with a minimum tier 1 leverage ratio of at least 3% and each ring-fenced bank should meet this on a solo basis. It also believes that international regulations should supplement the common equity surcharge for g-sibs referred to above with a graduated minimum leverage ratio for the largest banks. Even in the absence of such international agreement, it recommends that the leverage ratio for large UK ring-fenced banks should be increased to 4.06% and that there should be a sliding scale for smaller banks similar to that proposed for minimum equity requirements.

Loss-Absorbing Debt. In addition to minimum equity levels, the Commission believes at least some bank debt needs to be made more effectively loss-absorbing. It notes that there has been considerable international discussion, including by the EU and the Financial Stability Board ("FSB") in relation to bail-in debt under which losses can be imposed on creditors of a bank subject to resolution but short of insolvency. It also notes there has been considerable discussion at an international level on the use of contingent convertible instruments which are designed to convert into equity on a specified trigger (such as a bank's equity to rwas ratio falling below a specified level) whilst the bank remains a going concern. In view of continued uncertainty over how contingent capital will work in practice, the Commission focuses upon the use of bail-in debt and proposes that the special resolution regime applicable to banks under the Banking Act 2009 should be supplemented by a primary bail-in power and a secondary bail-in power.

The Commission envisages that the primary bail-in power would enable the UK authorities to impose losses on all unsecured debt of a bank in resolution with a term of at least 12 months at the time of issue ("bail-in bonds"). Bail-in bonds will be required to include a specific risk disclosure to reflect this power. To the extent possible, the contractual provisions of any foreign law governed bail-in bonds should make such debt subject to the primary bail-in power. If the primary bail-in power is not sufficient to enable the bank to be effectively resolved, the authorities should also have a secondary bail-in power to impose losses on all other unsecured liabilities. Appropriate safeguards should apply to the use of these powers, including that creditor hierarchy should be respected (subject to the effective subordination in resolution of bail-in bonds to other senior liabilities).

The Commission acknowledges that applying a bail-in power to liabilities other than bail-in bonds is complex and there may, in particular, be legal difficulties in applying such powers to foreign-law governed contracts and financial contracts protected under the Financial Collateral Arrangements Directive.[3] It also believes that actions taken by the resolution authorities should not be permitted to be triggers for the activation of termination or cross-default provisions. This will be challenging and will require amendments to standard form contracts and need international cooperation to succeed. The Commission also considers whether existing liabilities should be "grandfathered" from the bail-in powers. Somewhat surprisingly, its conclusion is that in view of existing powers under the UK special resolution regime, grandfathering should not be necessary. This is likely to be challenged and the subject of considerable lobbying during the legislative process.

Depositor Preference. As noted in the interim report, the UK does not currently provide any preference in an insolvency to bank depositors over other unsecured creditors. In relation to deposits which are guaranteed by the FSCS (and ultimately the UK taxpayer), the Commission states that such depositors are generally not well placed to exert market discipline on banks and have little incentive to do so but are required to take losses (reimbursed by the FCSC) at the same rate as other senior unsecured creditors. The Commission believes that giving insured deposits priority over other unsecured liabilities provides a market-based solution to the problems and shifts risks borne currently by the FSCS onto market counterparties, many of whom are better placed to exert market discipline on banks by demanding a higher return if the bank pursues riskier activities. It also notes that

[3] Directive 220/47/EC of the European Parliament and of the Council of 6 June 2002 on Financial Collateral Arrangements, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2002:168:0043:0043:EN:PDF.

depositor preference is already in place in a number of other jurisdictions including Australia, Hong Kong, Switzerland, and the U.S.

Amount of Loss-Absorbing Capacity to be Issued by Banks. The Commission also considers the minimum amount of bail-in debt that banks should issue. With regard to other regulatory reforms, it recommends that large UK ring-fenced banks or g-sibs headquartered in the UK that have a g-sib surcharge of 2.5%, be required to hold a primary loss-absorbing capacity of at least 17% of rwas. We show in the tables below examples of how that loss-absorbing capacity will be comprised. The Commission believe that both ring-fenced banks and non-ring-fenced banks should meet the minimum requirement on a solo basis. It believes that if a bank falls below the specified minimums, restrictions should be imposed on its ability to pay out discretionary distributions, including dividends and bonuses. Unless the Commission's proposal is adopted internationally, it does not believe that the UK subsidiaries of non-UK headquartered g-sibs should have to meet this requirement unless they are themselves UK ring-fenced banks.

Resolution Buffer. In addition to the requirement that the largest UK g-sibs and ring-fenced banks must be required to hold primary loss-absorbing capacity of at least 17% of rwas, the Commission believes that supervisors should have a broad discretion to increase this minimum to up to 20% with regard to factors relating to the ease of resolvability of the bank including the complexity of its structure and activities and the availability and likely effectiveness of resolution tools to reduce the impact of its failure.

Examples of Loss-Absorbency Requirements to be Applicable to UK Banks

	Large UK Retail Ring-Fenced Bank		UK Global Systemically Important Investment Bank
3%	Potential resolution buffer comprising loss-absorbing instruments if required by regulators	3%	Potential resolution buffer comprising loss-absorbing instruments if required by regulators
3.5%	Bail-in "bonds" (maturity at issuance of at least 12 months)	4%	Bail-in "bonds" (maturity at issuance of at least 12 months)
3.5%	Basel III non-core tier 1 and tier 2 equity (may include capital instruments)	3.5%	Basel III non-core tier 1 and tier 2 equity (may include capital instruments)
3%	UK retail ring-fence buffer (common shares or equivalent)	2.5%	G-sib surcharge (common shares or equivalent)
2.5%	Basel III Capital Conservation Buffer (commons shares or equivalent)	2.5%	Basel III Capital Conservation Buffer (common shares or equivalent)
4.5%	Basel III Core Tier 1 (common shares or equivalent)	4.5%	Basel III Core Tier 1 (common shares or equivalent)
20%		20%	

Percentage requirements are in relation to risk weighted assets.

Analysis of Loss-Absorbency Proposals

The ICB's proposals in relation to minimum equity requirements for UK banks are very close to those agreed upon at an international level, although it is clear from the Report that the Commission would have recommended higher minimum capital levels but for the levels agreed under Basel III. Although non-ring-fenced banks will not be subject to greater requirements than those agreed upon at international level (provided they meet certain criteria), large retail banks in the UK will be subject to a 3% equity buffer (by reference to their rwas). In practice, the fact that any such bank that is treated as a g-sib will be subject to an internationally agreed buffer of up to 2.5% (and the Commission accepts that the ring-fence buffer and g-sib buffer should not be cumulative), means that the difference between the minimum equity requirements for UK ring-fenced banks and international banks may not be massive. It could still, however, give rise to competitive disadvantages.

The Commission acknowledges that the draft EU legislative proposal in relation to CRD IV[4] (which will implement Basel III) currently envisages that member states would not have the ability to impose greater minimum equity levels than those prescribed under CRD IV. There is, however, likely to be some flexibility for member states and Michel Barnier, the EU Commissioner for Internal Market and Services, has previously stated that he believes there should be sufficient flexibility to allow the UK to implement the Committee proposals.

There is likely to be further debate on the Commission's proposals in relation to bail-in bonds and its recommendation that UK ring-fenced banks and large banks headquartered in the UK maintain a loss-absorbing capacity of between 17 and 20% of rwas. Similar issues are under discussion within the EU and the wider international community but the Report provides many more concrete proposals in this area than have so far been proposed internationally. The Committee's proposals may well now help frame the continued international debate in this area but they could ultimately be out of step with what is agreed to internationally. In this case, there would be a risk of UK banks being put at a competitive disadvantage if they were subject to different rules than other international banks. This is therefore likely to be one area where there will be further consultation as the UK legislative proposals are developed.

In relation to the Committee's proposals for bail-in debt, it acknowledges that it will be difficult for its proposals to be effective when applied to transactions governed by laws outside the UK without full international consensus and cooperation. Even with international consensus, the implications of making all debt with an initial maturity of at least 12 months subject to a primary write-down power effectively subordinates such debt to other senior debt of the bank. Initial suggestions are that such debt is unlikely to be treated as investment grade by investors and rating agencies. This will have a significant impact on the funding structure of banks in the future and may incentivise banks to seek more secured and short term funding where possible. The impact of the arrangements on credit default swaps relating to senior bank debt is also likely to be significant.

Competition

The Report also sets out an assessment of competition issues in UK retail banking markets. We do not set out the Commission's analysis in detail in this alert. Its principal conclusions and recommendations in this regard are:

- In relation to the commitment by Lloyds Banking Group ("LBG") to divest a retail banking business by 30 November 2013 ("Project Verde"), the Government should reach an agreement with LBG so the entity which results from the divestiture has a funding position at least as strong as its peers and has a share of the personal current market of at least 6%.

[4] See our client alert, "CRD – Maximum Harmonisation but Minimal Harmony? http://www.mofo.com/files/Uploads/Images/110822-CRD4.pdf.

- The Prudential Regulation Authority should work with the Office of Fair Trading to ensure that the prudential requirements for capital and liquidity do not unnecessarily limit the ability of new entrants to enter the market and compete effectively.
- A free current account redirection service should be established to smooth the process of individuals and small businesses switching current accounts. Such service should be fully operational by September 2013.
- The objectives of the new FCA should be amended to include an objective to promote effective competition in markets for financial services.

Timing and Next Steps

The Committee's recommendations are not binding but it states that it would like the UK Government to provide clarity for its views of the recommendations as soon as possible and move rapidly to put in place the necessary legislation and rules. It does, however, accept that there should be some lag time before the provisions take effect to enable banks to prepare for the significant changes that would result from the proposals being implemented. On loss-absorbency, the Commission considers that implementation should dove-tail with the current Basel timetable which envisages full implementation by the start of 2019. In relation to establishing the ring-fence, the Commission believes that the start of 2019 also represents a realistic timeframe, although it believes efforts should be made to complete necessary arrangements sooner.

Initial indications from the UK Government, including the Chancellor of the Exchequer, are that the Government is likely to accept all or most of the recommendations and seek to introduce legislation by the end of the current Parliament in 2015. Although there are criticisms in some quarters that this timetable is too slow, the changes represent very significant changes to UK banks and will require major restructuring of their current business structures. In addition, as we have highlighted above, a number of the recommendations are still in very broad terms and need further consideration and analysis before legislation can be finalised. As we have also highlighted above, a number of important proposals, including those relating to minimum equity requirements, loss-absorbency, and bail-in instruments tie in with work still being developed within the EU or at international level. It is important that the UK continues to participate actively in relation to such work. Although the recommendations in the Report may help frame some of these discussions, the Government may need to refine some of the recommendations to reflect continuing developments at the European and wider international levels.

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