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Reed Smith Analysis - Banking Reform: Delivering Stability and Supporting a Sustainable Economy, June 2012

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Authors: Jacqui Hatfield

Introduction

HM Treasury published the Paper on 14 June 2012. It sets out the Coalition Government's proposals for implementation of the Final Report by the Independent Commission on Banking chaired by Sir John Vickers (the "Vickers Report").

The objective of the reforms is for the UK to remain a successful global financial centre without asking taxpayers to bear unacceptable risks.

This is a clear intent to reduce the perceived implicit guarantees to the banking sector and all the undesirable consequences (uplifted credit ratings, etc.) that flow from the implicit guarantees.

2. The ring-fence – where and how high?

2.1 The services that will require ring-fencing ("mandated activities")

The only activity which will initially be mandated in primary legislation as requiring ring-fencing is accepting deposits. This will be limited through secondary legislation to deposits and overdrafts from individuals and Small and Medium Enterprises ("SME"). There will also be the power through secondary legislation to define additional mandated activities.

This approach is not designed to affect the ability of larger corporates to access services provided by ring-fenced banks. Conversely, individuals and SMEs will not be prevented from accessing a range of investment services from non-ring-fenced banks.

2.2 Who is covered by the ring-fence?

2.2.1 What are SMEs for the purposes of ring-fencing?

A quantitative limit will be used to determine whether a firm's deposits must be held by a ring-fenced bank. The threshold will probably be set by reference to firm turnover, or employee numbers, or a combination of both. A threshold for mandatory inclusion in a ring-fenced bank will be based on annual turnover. Firms with an annual turnover above this threshold would be permitted to place their deposits outside a ring-fenced bank.

The threshold is likely to be between the current turnover thresholds for the definition of SMEs under the Companies Act 2006: £6.5 million and £25.9 million.[1] The Paper does recognise that the annual turnover will fluctuate and proposes a basis for assessing this.

However, the Government is requesting views on how to manage the transition in practice when a firm's annual turnover falls underneath the threshold for a prolonged period (balancing the need to minimise disruption to customers, while ensuring that the ring-fence is not avoided).

2.2.2 What are high net worth individuals for the purposes of ring-fencing?

It is proposed that high net worth individuals be exempted from the requirement to place their deposits in ring-fenced banks. The Government believes that an appropriate threshold for exemption will be where individuals hold between £250,000 and £750,000 of free and investable assets with a single bank. However, discussions remain over the definition of free and investable assets.

In order to benefit from the exemption, the Paper also envisages a similar opting up process to the one found in the Market in Financial Instruments Directive. The Paper does recognise the possible fluctuation of free and investable assets (temporarily dipping below the threshold) and provides a basis for assessing this.

Again, the Government is requesting views on how to manage the transition where an individual falls beneath the threshold for a prolonged period.

2.3 Prohibited activities

Ring-fenced banks will be prohibited from carrying on international and wholesale and investment banking services. Primary legislation will require ring-fenced banks to refrain from carrying on any prohibited activity. Dealing in investments as principal will be a prohibited activity and will be defined in primary legislation. Further prohibited activities will be defined through secondary legislation.

2.3.1 Geographical restrictions

It is proposed that, where a ring-fenced bank operates in a wider group, non-EEA operations will have to be undertaken in separate subsidiaries of the group. It is expected that the significant majority of ring-fenced banks assets will be lending within the EEA.

There is a proposal for all major service and credit contracts to be written under the laws of an EEA Member State for ring-fenced banks (with certain exceptions, such as for the purpose of seeking wholesale funding outside the EEA).

Cross-border resolution agreements with other non-EEA jurisdictions are anticipated in order for the authorities to obtain a sufficient level of comfort that branches or subsidiaries in those countries will not present a barrier to resolution, nor an increased risk to the UK taxpayer.

2.3.2 Financial institution exposure restrictions

A power prohibiting a ring-fenced bank from entering into specific transactions with certain financial institutions is proposed. Certain exclusions from this prohibition are provided for including facilitating payments for other financial institutions, liquidity management, derivatives

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transactions for the purposes of ring-fenced banks' risk management, and wholesale investors holding the debt of ring-fenced banks.

These restrictions will also only cover certain types of financial institutions (for example, non-ring-fenced banks or investment firms).

2.4 Financial product restrictions

The following activities will certainly be prohibited activities:-

- Origination, trading, lending or making markets in securities (including structured investment products) or derivatives.
- Secondary market purchases of loans and other financial instruments.
- Conduit financing/securitisation of assets originated outside the ring-fenced bank.
- Underwriting securities issues.

However, a prohibited activities policy framework allowing a ring-fenced bank to sell simple derivatives to its customers (under a number of conditions to be set out in secondary legislation) will be examined by the Government. The Paper sets out the possible conditions in further detail (for example, the use of International Swap and Derivatives Association contracts, for hedging purposes, etc.). Please contact us if you require further information on these conditions.

Certain forms of structured retail deposits designed to provide bank depositors with higher returns by investing deposits in different types of market risk are mentioned in the Paper. The Government welcomes views on how simple retail investment products may be provided by ring-fenced banks in a way that is consistent with the Paper.

2.5 Ancillary activities

Secondary legislation will set out exemptions to prohibited activities for the purposes of:

- managing balance sheet risks;
- liquidity management; and
- raising funding.

However, these exemptions may be subject to safeguards.

In relation to wholesale funding, the aim of reducing dependency on short-term wholesale funding is supported by the Government. However, the Government does not support introducing a separate limit on wholesale funding for ring-fenced banks at this stage.

2.6 Intra group relationships

Ring-fenced banks must be genuinely independent from other parts of the group. It is therefore proposed that primary legislation provides that the regulator ensures that a ring-fenced bank treats, and is treated by, other members of its group as a third party. This means, for example, that any group services will need to be provided on an independent arm's length basis.

This may require the regulator to impose requirements on different entities in a banking group, including unregulated parent entities of a ring-fenced bank. The Financial Services Bill confers substantive powers on the authorities in relation to certain unregulated parent undertakings of authorised persons. The extension of these powers for ring-fencing is still being explored.

2.6.1 Legal and operational links

Ring-fenced banks will be required to be separate legal entities from non-ring-fenced banks. The subsidiaries a ring-fenced bank may have (there will be exceptions for essential operational subsidiaries) will also be restricted.

However, where the operational infrastructure of a banking group (management, information systems, information technology, employment structures, etc.) presents a barrier to the ring-fencing, the regulator will require firms to make appropriate changes. In addition, the Paper provides that the provision by ring-fenced banks of payment services to non-ring-fenced banks will be subject to approval.

2.6.2 Economic Links

The Paper proposes:-

- That ring-fenced banks will be expected to meet capital and liquidity requirements on a standalone basis (unless there are a number of ring-fenced banks in a single group in which case a sub-consolidation group of ring-fence banks may be appropriate).
- That the limits on intra-group exposures are to be treated as if those exposures were between third parties.[2]
- That although there are not comparable large exposure limits between third parties measured gross of collateral, there is a strong argument for imposing such limits on exposures between ring-fenced banks and the rest of their groups, subject to EU law.
- To set limits on the proportion of the funding that a ring-fenced bank receives from the rest of its group, and for the terms of that funding to be regulated.
- To consider whether the regulator should set out rules in a number of areas (intra-group guarantees, cross default clauses, intra group netting arrangements, etc.) where there may be potential for transactions that seek to avoid the impact of the Paper.

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2.6.3 Governance

At least half the board of the ring-fenced bank, excluding the Chair (who should be independent upon appointment), will be independent. In addition, it is proposed that no more than one third of the members of the ring-fenced bank's board may be representatives of the rest of the bank's group.

A requirement, implemented via the Approved Persons regime, for directors of the ring-fenced bank and the parent company, to protect the integrity of the ring-fence has been proposed.

In order to maintain independence, there is a proposition for ring-fenced banks to have their own board committees, in particular regarding risk, and possibly nomination and remuneration.

2.6.4 Disclosure

Significant ring-fenced banks will already be required to make a number of public disclosures under Pillar III and other existing regulatory and listing requirements. Where this is insufficient to demonstrate independence and viability, the regulator will have, subject to EU law, a broad power to require any additional disclosures in order to demonstrate this.

2.6.5 Tax

The joint and several liability from VAT grouping has the potential to undermine the ring-fence. Although the issue is still being explored, the Paper states that this issue could be mitigated, for example by requiring non-ring-fenced banks to place a deposit or security with ring-fenced banks.

With regards to the use of trading losses for offsetting future profits, tax will be paid earlier due to the separation of the entities by the ring-fence.

2.6.6 Pensions

The preferred option is for banks to separate, using commercial means, the pension fund for employees of a ring-fenced bank from the pension funds of other group entities, to ensure that the ring-fenced bank cannot be made jointly and severally liable for any pension deficit. Banks will be allowed until 2025 to achieve the full separation.

2.7 Scope of the proposals

The building societies sector will be carved out of the ring-fencing legislation but will be subject to the general loss-absorbency measures. The current legislation will then be brought in line with ring-fencing requirements by making appropriate amendments to the Building Societies Act (1986). The "Future of Building Societies" is expected to be published shortly and will contain the Government's aspirations for building societies.

2.7.1 De minimis

It is likely that there will be a de minimis threshold set at £25 billion of mandated deposits. Small UK banks not meeting this threshold will not be required to ring-fence their deposits from individuals and SMEs.

As firms approach the thresholds for exemption, either from below or above, in order to ensure consistency, the Government will consider with the regulator whether additional prudential safeguards should be applied to certain exempted banks.

2.7.2 Branches of non-EEA headquartered firms

The exemption thresholds will also apply to EEA branches of non-EEA headquartered firms.

3. Loss-absorbency

3.1 Primary loss absorbing capacity ("PLAC")

According to the Paper, banks should hold minimum levels of effective loss-absorbing capacity that bear losses ahead of other liabilities to ensure they are sufficiently resilient to shocks, and so that they can be resolved without recourse to the taxpayer.

The largest banks will require a 17 per cent PLAC. Importantly, an exception from the PLAC requirement is proposed for those overseas operations of UK-headquartered global systemically important banks ("GSIB") which can prove that they will not pose a risk to EEA financial stability.

PLAC requirements will be imposed against overseas operations if:

- the scale of a firm's activities in the UK is significant; and
- the failure of those operations would undermine the viability of the group's UK operations, and threaten UK and/or EEA financial stability.

Notwithstanding the application of the overseas operations exemption, all UK-headquartered GSIBs will still be subject to PLAC requirements against risk-weighted assets ("RWA") in all UK ring-fenced banks and all UK non-ring-fenced banks.

However, in light of the common European frameworks on capital requirements ("CRD IV") and on recovery and resolution, the above overseas operation exemption may be more appropriate to apply to RWA exposures in non-EEA entities only – rather than differentiate between exposures in different Member States. This will be monitored.

A bank which drops marginally below its PLAC requirement, but still has a large amount of equity, will not be considered non-viable. In this case, supervisors may have scope to apply restrictions on distributions.

3.1.1 The ring-fence buffer

It is proposed that the largest UK ring-fenced banks and the largest UK building societies should hold an equity "ring-fence buffer", bringing their minimum equity capital requirements to at least 10 per cent of RWAs. This is an addition to the 3 per cent required under Basel III.

However, this 'ring-fence buffer' and any GSIB surcharge will not be additive so, if an entity is a ring-fenced bank and part of or is a GSIB, only the higher of the two requirements should apply. Both requirements would be additional to the base capital conservation buffer of 2.5 per cent, and to any counter-cyclical buffer.

The breach of the 'ring-fence buffer' will lead to regulatory restrictions on capital distributions (such as dividends and bonuses) so that a bank's equity levels are rebuilt.

Assuming the necessary powers are conferred on it through the European legislation, the regulator will apply the full 3 per cent buffer to the biggest ring-fenced banks, no buffer to the smallest and possibly a scaled approach for banks in between.

3.1.2 Leverage ratio

The Paper will not permanently increase the minimum leverage ratio beyond the Basel III international standard for large ring-fenced banks. The 17 per cent of RWAs is considered appropriate PLAC requirement for the largest ring-fenced banks.

3.1.3 Bail-in

This proposed statutory tool will ensure that at least some unsecured non-capital liabilities can absorb losses without having to put a bank or part of it into insolvency. This will be particularly applicable where there is a potential failure of a systemically important institution. Thus creditors will reap rewards when banks do well, but take the pain if banks fail. Creditors will surely demand a higher return to compensate for this.

The bail-in power will have a statutory basis, with the relevant authorities determining when the trigger is met and the terms of the write-down of liabilities. It shall not depend on the inclusion of any specific clause within a debt contract.

It is likely that the statutory bail-in power will cover a broad range of a bank's unsecured liabilities to ensure that there is as big a pool as possible to absorb losses. The bail-in power will also respect the normal creditor hierarchy between creditor classes in insolvency.

The Paper provides for the assessment of suitable liabilities for the bail-in. They cover those that are (i) technically feasible to bail-in within a short period of time; (ii) unlikely to create undesirable or unintended consequences if subject to bail-in; and (iii) able to suffer losses in insolvency.

The European Commission Recovery and Resolution Directive proposals ("RRD Proposal") include a number of exclusions from the scope of the bail-in tool. Therefore, the Government will work on the scope of the bail-in power during the course of the RRD negotiations.

The Paper clearly states that additional work is required to determine how debt instruments governed by foreign law can be credibly subject to the UK's statutory bail-in power.

A possible addition to the statutory bail-in power is proposed in the Paper. Banks can explicitly provide in the terms of at least some long-term unsecured bonds that they were subordinate to senior unsecured liabilities in insolvency (avoiding the need for legislative subordination) and that they would be bailed-in prior to senior unsecured debt and all other liabilities ranking equally with senior unsecured debt in the creditor hierarchy. However, the terms of these instruments would not specify the terms under which a bond would be written down or converted. These and other parameters would be determined at the discretion of the resolution authority each time the power is exercised. In the Paper, the Government seeks views on this potential addition and sets out its potential advantages.

3.1.4 PLAC Composition

The Government believes that PLAC should comprise the highest quality loss-absorbing instruments – that is capital (equity, Additional Tier 1 ("AT1"), Tier 2 ("T2")) and long-term unsecured debt that is clearly identified as subject to the bail-in power. It is also important to ensure that PLAC composition is consistent as far as possible with the outcomes of the RRD negotiations for a minimum requirement for eligible (bail-inable) liabilities. Firms can meet PLAC requirements using any eligible regulatory capital resources or sufficiently high quality bail-inable debt, whether or not the regulatory capital resources are also used to meet other capital requirements. However, the Government also takes the view that supervisors' assessments of Pillar 2 capital add-ons should be based on the CRD IV provisions and should not impinge on the choice of a bank to meet its PLAC requirement (above the regulatory capital minima) through eligible debt instruments rather than capital.

Since no bank currently issues such bail-inable instruments, if this approach were adopted it may be difficult for expect banks to meet their PLAC requirement until a market for them develops. Therefore, proposals are made for either a transition period or a phase-in period (further discussed in the Paper).

Taking into account the proposed RRD, it will also be important to provide clarity on whether subordinated debt currently in issuance that does not qualify as AT1 and T2 should be eligible to count towards PLAC

3.1.5 The bail-in process

The regulatory trigger will be the same for all resolution tools. It will be a pre-insolvency trigger, linked to the bank no longer meeting (or being unlikely to meet) the threshold conditions and there being no reasonable likelihood of remedial action being taken by or in respect of the bank to bring it back into compliance with the threshold conditions.

In either case, the resolution authority would respect the creditor hierarchy in insolvency to the extent possible (it may be necessary to depart from the principle of equal treatment of similarly situated creditors where appropriate). Compensatory measures may need to be put in place in relation to the affected creditors in order to ensure compliance with the European Convention of Human Rights.

3.1.6 Transition arrangements

It is accepted that some transition period for PLAC will be required. This will give investors time to appropriately quantify the risk of the bail-in tool being used. Credit rating agencies will also need time to help them adjust their ratings methodologies to reflect the bail-in powers, and it will take time for asset managers to inform clients so they fully understand the changes and for investor mandates to adjust to accept the debt markets in this new form. Similarly, banks need to be given sufficient time to manage their liabilities, to ensure that any funding cost changes can be managed smoothly. The restructuring of legal entities within banking groups – necessitated by the ring-fencing – presents a further transition issue that is likely to impact on (at least some) existing bondholders.

3.1.7 Tax treatment of the PLAC instruments

The Government has provided assurance that, if necessary, it will legislate in order to provide certainty for the tax treatment of debt instruments qualifying as PLAC.

3.2 Depositor preference

The Paper proposes to change the creditor hierarchy, as far as permitted by EU legislation, so that deposits entitled to FSCS protection ('insured deposits') are preferred (or more specifically the FSCS standing in the shoes of insured depositors is preferred) in an insolvency.

However, the Paper admits that some issues need to be resolved (for example, the impact of placing insured depositors above banks' own pension fund liabilities in the creditor hierarchy; or the risk to public funds or socially valuable activities that may arise if deposits placed by charities or local authorities are subordinated to FSCS claims).

Subject to the outcome of the RRD negotiations, including the final design of any agreed bail-in tool, the Government proposes to amend the Insolvency Act 1986 to provide that, with effect from 1 January 2019, insured deposits should be made preferred debts.

On this issue, the Government will seek views on the following:-

- Is there a case for preferring any other liabilities alongside those of the FSCS?
- Regardless of local insurance schemes, should the preference proposed for insured deposits be extended to include the equivalent sum of non-EEA deposits held in non-EEA branches of UK-incorporated entities?

3.3 Changes to the costs that may be covered by the industry levy

Amendments will be made to the Financial Services and Markets Act 2000 to enable the successor authorities to the FSA to levy the industry to pay for the costs incurred by HM Treasury in representing the United Kingdom on the international stage.

4. Competition

The final part of the Paper sets out how the Government is taking a number of specific measures to further improve competition in UK banking. For further details on these specific measures, please contact us.

5. Consultation and implementation

The Government intends to introduce all necessary legislation by the end of this Parliament in May 2015. Banks must comply with all of the measures proposed here by 2019.

The Government will offer a draft Bill for pre-legislative scrutiny in the autumn, and – subject to this consultation – make provisions for these measures. The Government seeks views on the proposals (which include 14 multi-part consultation questions) in the Paper. Responses are requested by 6 September 2012.

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[1] If the threshold were set at an annual turnover of £6.5 million, 96 per cent of all enterprises (43 per cent of enterprises by employment) would be covered. If the threshold were set at £25.9 million, 97 per cent of all enterprises (53 per cent of enterprises by employment) would be covered.

[2] The current Large Exposures regime (Directive 2009/111/EC) limits an institution's banking book exposures to any counterparty, group of connected clients or connected counterparties to 25 per cent of the institution's regulatory capital. In addition, the institution must not incur large exposures which in total exceed 800 per cent of regulatory capital.