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Re-fencing: the pitfalls, and opportunities, of M&A for ring-fenced banks

Feature

KEY POINTS

- Article 11 of the Financial Services and Markets Act (Ring-fenced Bodies and Core Activities) Order 2014 (RFBCAO) as amended does not cater for the scenario where acquiring group is a ring-fenced bank prior to an acquisition of financial services business – such that the acquired business would become subject to the ring-fencing regime in full on and from the date of completion of the acquisition.
- This means a ring-fenced bank will almost certainly be in breach of the ring-fencing regime as soon as it completes the acquisition.
- For HSBC UK Bank plc's (HSBC) recent acquisition of Silicon Valley Bank UK Limited (SVB UK), certain changes to the ring-fencing regime were made with relative ease because SVB UK was acquired by HSBC through resolution, under the Banking Act 2009, which provides Treasury with the power to change the law for the purpose of enabling the special resolution powers to be "used effectively".

The UK's bank ring-fencing regime puts barriers in the way of mergers and acquisitions by ring-fenced bodies. The government has recently evidenced its intention to relax these, both as part of its review of the regime generally and, during times of crisis, for specific acquisitions.

This article outlines the concessions already provided for in the ring-fencing regime and highlights the remaining challenges, particularly for acquirers which are already subject to the ring-fencing regime. (This article does not seek to examine the policy arguments for and against the ring-fencing regime, which have been examined as part of the Ring-fencing and Proprietary Trading Panel Report (referred to as the Skeoch Report) and which are subject to further consideration under a government consultation which is open for response at the time of writing.)

Since 2019, the UK's six largest banks have been subject to a ring-fencing regime,[1] under which their retail deposittaking and related activities are structurally separated from certain investment banking activities, including most derivatives trading and proprietary investment activities, and the operation of subsidiaries or branches outside the UK and EEA. Within a group, banks undertaking retail deposit-taking business (ring-fenced banks or RFBs) must manage exposures to affiliates undertaking investment banking activities (non-ring-fenced banks or NRFBs) within large exposures limits under the regulatory capital framework, without the benefit of any waivers from the UK Prudential Regulation Authority (PRA). RFBs are prohibited from incurring exposures to certain classes of financial market participants (so-called relevant financial institutions (RFIs)) and must be able to access payment systems directly or via a ring-fenced affiliate. These restrictions also apply to subsidiaries and affiliates of an RFB, where it operates from a sub-group within a wider banking group. The regime is designed to ensure that the critical services provided by RFBs – in particular, the retail deposits business and related activities – can more easily be preserved in a time of stress or failure.

However, where a bank proposes to grow by way of acquisition, the threshold can be crossed quite suddenly. The ringfencing regime acknowledges this in a couple of ways:

- Article 11 of the Financial Services and Markets Act (Ring-fenced Bodies and Core Activities) Order 2014 as amended (RFBCAO) provides for a four-year transitional period for:
  - banking groups which cross the Ring-fencing Threshold as a result of an acquisition effected by an instrument under the Banking Act 2009 (BA 2009); and
  - banks which become an RFB as a result of the exercise of powers under BA 2009 (for example, an order is made to transfer the shares of that bank to an RFB) (a Resolution Acquisition).
  - Similarly, Arts 12 and 13 of the RFBCAO together provide for a four-year transitional period for groups which acquire a target institution through private means (a Private Acquisition) where such acquisition causes the group to cross the Ring-fencing Threshold.

In both circumstances, the group has a period of four years from the date of completion of the acquisition before the banks within the group (both those prior to the acquisition and any acquired by way of share sale (ie any Target) will be treated as RFBs.

This four-year period is intended to allow for changes to the business acquired (whether acquired as assets and liabilities or as shares in a subsidiary institution) (the Acquired Business) to bring the Acquired Business into alignment with the ring-fencing regime.

However, neither of the two circumstances provided for in the RFBCAO and set out above caters for the scenario whereby the acquiring group is an RFB prior to the acquisition. In that case, the acquiring group will be fully subject to the ring-fencing regime before the acquisition and the Acquired Business would – absent some sort of concessions – become subject to the ringfencing regime in full on and from the date of completion of the acquisition.

CHALLENGES

Ring-fencing imposes esoteric and highly technical restrictions on the activities which an RFB undertakes, and the clients and counterparties with which it deals. No Target is ever likely to run its business in compliance with those requirements, unless it itself is within the regime. As the requirements are applied to subsidiaries of an RFB, the corollary is that the RFB will almost certainly be in breach of the ringfencing regime as soon as it completes the acquisition. This makes acquisitions of nonring- fenced businesses highly challenging for RFBs that may wish to acquire a new entity, or new business, as a result – either in the case of a Resolution Acquisition or a Private Acquisition.

HSBC UK Bank plc's (HSBC's) recent acquisition of Silicon Valley Bank UK Limited (SVB UK) helps illustrate the point. In that instance, the UK government amended the ring-fencing regime so as to facilitate the acquisition by:

- waiving requirements that intra-group transactions between HSBC and SVB UK be conducted on arm's length terms; and
- permitting the PRA and the UK Financial Conduct Authority (FCA) to amend or waive their rules, without the need for SVB UK to proactively apply for waivers or consultation on such amendments, where such amendments or waivers are intended to facilitate, or are in consequence of, the resolution of SVB UK. Subsequently, HSBC and SVB UK have been granted PRA approval to include SVB UK in HSBC's domestic liquidity sub-group (allowing for liquidity requirements to be met on a consolidated basis) and SVB UK has been granted waivers to permit solo reporting to the PRA.

These sorts of changes to law can be made with relative ease in the context of a Resolution Acquisition, as s 75 of BA 2009 provides Treasury with the power to change the law for the purpose of enabling the special resolution powers to be "used effectively". Such support is not available in the context of a Private Acquisition – including where a Private Acquisition is being contemplated as a means of rescuing a potentially failing bank without the need for that bank to be resolved under BA 2009 – and this may have been a reason why the Bank of England ultimately chose to rescue SVB UK through resolution. In and of themselves, changes to law will also not alter the application of PRA Rules.

More specifically, depending on the context, the following concerns may arise:

- The Acquired Business may be a mix of business which is permitted and business which is not permitted for ring-fencing purposes. The four-year transitional periods provided for in the RFBCAO are intended to allow for post-acquisition restructurings of such business to ensure that any remaining inside the ring-fence beyond that time is permitted. However, as indicated above, there is no transitional period in the case of Private Acquisitions by a pre-existing RFB outside of resolution. In any case, the four-year period may not be long enough where substantial restructuring is required.
- Where the Acquired Business is such that certain deposits would need to be held outside the ring-fence, Arts 3(3) and 18(2) of the RFBCAO, together with related FCA Rules, require that appropriate notifications be given to the affected depositors. This may not be permissible pre-acquisition, as it would require sharing of customer data with the acquiring Group.
- Where the Acquired Business accesses payment systems via a third-party clearing bank, that relationship will need to be transitioned to an affiliated RFB. There may be contractual restrictions under the existing thirdparty contract.
- Where the Acquired Business includes exposures to RFIs, which are prohibited, such exposures will take time to fully identify and may not be readily capable of being transferred to an NRFB or otherwise unwound.
- A number of waivers of PRA Rules applying to RFBs are likely to be required. For example:
- The PRA requires ring-fenced affiliates to comply with certain PRA Ring-fenced Bodies Rules as if it were an RFB. A waiver of this requirement is likely even in the case of a Target in the four-year transitional period referred to above.
- The Target may (coincidentally) be receiving services from the non-ringfenced members of the acquiring Group, which would be prohibited post-acquisition.

The above is intended to be illustrative – it is by no means exhaustive. Any acquisition scenario will give rise to idiosyncratic and complicated concerns. Arguably, this is good reason to ensure that the ring-fencing regime provides for suitable concessions, including an appropriate transitional period, for acquisitions by RFBs.

Biog box

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OPPORTUNITIES

The HSBC acquisition of SVB UK also illustrates the significant opportunities not only for the UK's RFBs, but also for the UK authorities tasked with ensuring financial stability, in possible mergers and acquisitions activity. Smoothing the path for the UK's RFBs, which by definition comprise some of the UK's largest banks with the deepest pockets of liquidity, to acquire smaller institutions would ensure that the authorities – when faced with a stressed or failing Target – have the best chance of brokering a private sector solution.

CHANGES AFOOT?

The Skeoch report, released in March 2022,2 acknowledged some of the barriers that the ring-fencing regime poses to bank M&A and recommended that "transitional periods for complying with ring-fencing rules should be introduced for mergers and acquisitions of banks". The UK government has subsequently expressed its intention to consult in the first half of 2023 on a number of "near-term" reforms to the ring-fencing regime, including to "[t]ake forward technical amendments outlined in the [Skeoch report] to improve the functioning of the regime, removing unintended consequences, and providing benefits for the sector and the economy"; such technical amendments are expected to include provision for greater flexibility for RFBs to undertake mergers and acquisitions activity. At the time of writing, the expected consultation paper is yet to be published, and so precisely which changes the government intends to take forward or in what manner remains subject to speculation.

In considering how best to legislate for suitable concessions, the government will need to consider possible unintended consequences and whether more can be done to smooth the path for Resolution Acquisitions. As to the former (unintended consequences), for example, were a four-year transitional period to be provided for, that would have the effect that any Target would be an RFI whilst also being a member of the RFB sub-group, thereby limiting the funding that could be provided by the acquiring group without PRA rule waivers. As to the latter (what more can be done), upfront clarity on the concessions the authorities may be willing to make would alleviate the issues to be resolved over a so-called "resolution weekend".

1 Provided for under Pt 12B of the Financial Services and Markets Act 2000 (FSMA), the FSMA (Ring-fenced Bodies and Core Activities) Order 2014 (RFBCAO), the FSMA (Excluded Activities and Prohibitions) Order 2014 (EAPO) and associated rules and guidance of the UK Prudential Regulation Authority (PRA).

2 Available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1060994/CCS0821108226-006_RFPT_Web_Accessible.pdf

Further Reading:

- Ring-fencing and M&A: acquisitions of and by UK banks and their affiliates (2019) 8 JIBFL 527.
- The UK's bank ring-fencing legislation: legal uncertainties and potential solutions (2022) 2 JIBFL 70.
- Lexis+® UK: UK structural banking reform – ring-fencing.