

Client Alert

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UK Banking: Ringing in the Changes

It has been three years since the Independent Commission on Banking (the “IBC”), chaired by Sir John Vickers, published its final report and recommendations on the reform of the UK banking system in response to lessons learnt during the financial crisis (the “Report”)¹. As part of the Report’s suggested package of solutions, it was proposed that UK banking stability required structural reform in order to ring-fence (from risks present elsewhere in the financial system) banking services that are integral to the provision of payments services to customers in the European Economic Area (EEA). Since publication of the Report, the UK Government has implemented many of its recommendations through the *Financial Services (Banking Reform) Act 2013* (the “Banking Reform Act”), which came into force in December 2013. Amongst other things, the Banking Reform Act (primarily through amendments to the *Financial Services and Markets Act 2000* (“FSMA”)²) lays the foundations for the ring-fencing requirement, defining the ‘core activities’ which should be quarantined within the ring-fence³ (a “Ring-Fenced Body” or “RFB”) and restricting RFBs from performing certain ‘excluded activities’⁴.

On 6 October 2014, the Prudential Regulation Authority (“PRA”) published proposed rules and sought feedback in respect of a package of measures designed to promote resilience and resolvability in the UK banking sector⁵. The PRA’s publications include consultation paper CP19/14 (the “Consultation”) on the implementation of ring-fencing, which provides a draft supervisory statement covering legal structure, governance and the continuity of services and facilities. This update aims to highlight some of the PRA proposals, as well as confirm that all affected firms are expected to submit preliminary plans detailing their anticipated legal and operational structures by 6 January 2015.

Legal Structure

One concern of the PRA highlighted in the Consultation, is that prohibiting an RFB from conducting excluded activities will be insufficient to meet the objectives of ring-fencing, to the extent that the RFB is structurally connected to either a parent or subsidiary entity that is able to conduct such activities. This might be, for example, because of losses being passed to an RFB from a subsidiary, or because a parent company might restrict an RFB’s ability to make independent decisions⁶. It is argued, therefore, that RFBs need to be protected from risks arising in relation to connected entities. Accordingly, it is proposed that:

¹<http://webarchive.nationalarchives.gov.uk/20131003105424/https://hmt-sanctions.s3.amazonaws.com/ICB%20final%20report/ICB%2520Final%2520Report%5B1%5D.pdf>

² See Part 9B of the FSMA, as set out in Section 1(4) of the Banking Reform Act.

³ See also *The Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014*.

⁴ See also *The Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014*.

⁵ These included (aside from the ring-fencing consultation) CP21/14 on the rules relating to insurance policyholder protection, CP20/14 on the rules relating to depositor protection, as well as a discussion paper on ensuring operational continuity in resolution (DPI/14).

⁶ Part 9B of the FSMA at Section 142H provides that the PRA must make rules that provide for certain “group ring-fencing purposes”, one of which is to ensure that an RFB is able to make decisions independently of other members of its group (see Section 142H(4)(b)(i)).

1. entities undertaking excluded or prohibited activities may not have an ownership interest⁷ in an RFB; and
2. an RFB may not have an ownership interest in entities undertaking excluded or prohibited activities.

As a consequence, the PRA advocates what is commonly referred to as a ‘sibling structure’, whereby one or more sister companies are used to engage in excluded or prohibited activities. Such companies can be owned by a common parent holding company, although the RFB should not have direct controlling interest in or be owned by those companies. The PRA states that future consultations will further enhance this structural separation by setting out the extent to which RFBs are able to assume exposures to sibling entities and enter into intragroup transactions.

It should also be noted that “in principle” the PRA does not necessarily object to RFBs owning undertakings that are not conducting excluded or prohibited activities. However, it states that this will be considered on a case-by-case basis, taking into account the PRA’s objectives. The Consultation makes no mention, however, of the PRA’s view in the case of RFBs being owned by entities undertaking such activities.

Governance

The FSMA requires the PRA to make rules on RFB board membership, risk management, remuneration policy and HR policy. While the PRA acknowledges that its existing rules in these areas already partly satisfy the group ring-fencing purposes⁸, it also recognises that certain amendments are required at the level of the RFB, where existing rules are deemed to be insufficient:

General Rules

- RFBs must be able to make decisions independently of other members of the group;
- RFBs must take all reasonable steps to identify and manage conflicts of interest with other group members;
- RFBs must take reasonable steps to identify and manage any conflicts between the duties that senior management owe to the RFB and other interests they may have; and
- RFBs should be able to demonstrate how they are meeting the requirements of the ring-fencing rules.

Requirements for an RFB’s Board Committee

- at least half of an RFB’s board, excluding the chair, must be independent non-executive directors; the chair of an RFB must be independent during his or her tenure as chair;
- the chair of an RFB must not hold another chair position in another group entity board;
- no more than one third of an RFB’s board members may be current employees or directors of another entity in the group;
- an RFB executive board director must not hold other executive director positions on the board of another entity in the group that carries out excluded or prohibited activities; and
- an RFB must have its own risk, nomination, audit and remuneration non-executive board committees.

⁷Ownership interest includes, but is not limited to, shares, voting rights, or other rights to participate in capital or profits.

⁸ The “group ring-fencing purposes” (Section 142H of FSMA) are (a) ensuring as far as reasonably practicable that the carrying on of core activities by a ring-fenced body is not adversely affected by the acts or omissions of other members of its group; (b) ensuring as far as reasonably practicable, that in carrying on its business, a ring-fenced body: (i) is able to make decisions independently of other members of its group, and (ii) does not depend on resources which are provided by a member of its group and which would cease to be available to the ring-fenced body in the event of the insolvency of the other member; and (c) ensuring as far as reasonably practicable that the ring-fenced body would be able to continue to carry on core activities in the event of the insolvency of one or more other members of its group.

Risk Management and Internal Audit

The PRA already has strict rules in place governing the need for adequate risk management and control processes by banking organisations⁹. However, in addition to the existing requirements, the Consultation explains that an RFB must have its own risk management and internal audit capability. Such resources must be sufficient to enable the RFB to make decisions independently of the rest of the group. As such, while it can operate as a part of a wider group policy, the bank must be able to demonstrate that it is at least capable of operating on a separate and sufficiently resourced basis. Although certain systems and resources can be shared with other group members, there must be robust, arm's length terms governing the way in which costs and resources are attributed.

In addition, RFBs will require the appointment of their own heads of risk management and internal audit. Again, there is no reason why these individuals cannot report to more senior risk managers at the group level, although they would also be expected to report to the RFB board committees.

Remuneration

The Consultation states that remuneration for RFB employees should be determined at the level of the RFB. This does not automatically have to be a separate remuneration policy from the rest of the group but to the extent that it is considered that the group policies are inconsistent with the sound and effective risk management of the RFB, applicable adjustments should be made.

HR Policies

Requirements in this area already exist in the Senior Management Arrangements, Systems and Controls sourcebook ("SYSC") contained in the PRA Handbook. In addition, however, the PRA has proposed that RFBs should not become dependent on personnel who might not be available in the event of the insolvency of another member of the group. Such dependence might arise as a result of a range of factors, including how substitutable the relevant personnel's skills are. This is not, however, intended to mean that personnel cannot provide services to more than one entity within a group structure.

Vacancies in respect of non-executive director positions on the RFB's board should also be advertised publicly, in order to promote transparency and independence. An exemption is proposed to be provided for the chair, on the basis that such an individual may need to be appointed quickly in an emergency, to restore confidence and stability.

Individual Accountability

Senior managers of RFBs will be required to take on 'prescribed responsibility', ensuring compliance with ring-fencing requirements in the specific areas of the firm for which they have responsibility. It is expected that such responsibilities should be allocated to all senior managers on the board of an RFB, as well as most (if not all) of the RFB's other senior managers. Such prescribed responsibility may also extend to senior 'group level' managers in circumstances where they have responsibility for managing any area of the RFB's business. Banks would be required to set out such allocations in Statements of Responsibilities when applying for approval of a prospective senior manager and would provide formal evidence of the areas that such individual is responsible for managing for the purpose of supervisory discussions and enforcement action.

⁹ A summary of the PRA's Threshold Conditions and Fundamental Rules and its approach to banking supervision, can be found here: <http://www.bankofengland.co.uk/publications/Documents/prapproach/bankingappr1406.pdf>.

Continuity of Service and Facilities

One of the primary aims of the ring-fencing requirement is to ensure continuity of essential services in the event of the insolvency, acts or omissions of other banking group members. To reinforce this requirement, the Consultation proposes that there be additional restrictions placed upon:

1. intragroup service arrangements entered into by an RFB; and
2. RFB service arrangements with non-group entities that could be affected by the financial position of the wider group.

The PRA highlights that the above restrictions are not intended to internalise all service functions of an RFB, although any external arrangements will be subject to limitations. In particular, the PRA proposes that an RFB may only utilise shared services of an intragroup entity in circumstances where it either (a) forms part of the RFB's sub-group¹⁰, or (b) is a dedicated intragroup service entity. In the latter case, this is referring to entities whose only business is to provide such services within the group. In addition, to the extent that there are any intragroup or third-party service arrangements, the PRA requires that it should not be possible for other group members to disrupt these arrangements through their own acts, omissions or insolvency. This requirement, however, need only apply in respect of service arrangements that might affect an RFB's ability to conduct its core activities.

Next Steps

On the basis that the government's broader ring-fencing proposals have been in the making for some time, we expect and understand that most (if not all) UK banks will have already been considering some of the key structural and legal reforms that will be required to make them compliant. It now seems that any such advance planning would have been particularly prudent, given the Consultation's relatively tight deadline of January 6, 2015, for banks to formulate their preliminary proposals regarding their revised legal and operating structures and calibrate them in preparation for submission in accordance with the additional rules and regulations described above¹¹.

The same deadline of 6 January 2015 has also been provided for the provision of any views or comments on the Consultation's proposals. It is expected that the PRA will enter into further consultations during the course of 2015 and will publish the final rules and supervisory statements during the first half of 2016.

Finally, it should also be noted that the consultation process for creating rules on ring-fencing in the UK is being carried out alongside the European Commission's work on the structural reform of European Banks¹². Accordingly the Consultation makes clear that the PRA proposals remain subject to any amendment required in order to facilitate compliance with rules promulgated at the EU level.

¹⁰ As mentioned above under "Legal Structure", an RFB will be able to form a sub-group with other group entities, provided those entities do not conduct any excluded or prohibited activities.

¹¹ The proposals should include (i) provisional UK holding company and UK regulated entity balance sheets and profit and loss statements (such that the regulators can consider the sustainability and viability of the entities and their level of going and gone-concern capitalisation); (ii) a project plan demonstrating how the firm will transition into the revised group structure; (iii) details of any authorisations, permission or waivers likely to be required; and (iv) any transfers under the FSMA, Part VII (Control of Business Transfers) which require regulatory approval.

¹² See <http://media.mof.com/files/Uploads/Images/140131-Separation-Anxiety.pdf>.

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