UK Bank Ring-Fencing: Credit and Rating Implications

The major UK banks have detailed their ring-fencing plans, allowing Scope to provide initial thoughts on credit and rating implications. In general, Scope does not take the view that debt investors in ring-fenced entities of a group are automatically better off than debt investors in non-ring-fenced entities of the same group. We believe ring-fencing is mainly intended for the benefit of retail customers rather than institutional investors. It is not clear that ring-fenced entities would be given preferential treatment under the Bank of England's preferred resolution strategy – bail-in at the holding company level.

In this report, we focus on the four UK banks we rate publicly: Barclays Bank plc (A+ Issuer Rating, Stable), HSBC Holdings plc (AA, Stable), Lloyds Bank plc (A+, Stable), and The Royal Bank of Scotland plc (A-, Stable).

The objectives of ring-fencing

By 1 January 2019, UK banks with more than GBP 25bn in retail deposits will be required to separate core domestic retail banking services from other activities, such as investment and international banking. These requirements, known as structural reform or ring-fencing, are part of a package of reforms being implemented in response to the financial crisis and to improve the stability of the UK financial system.

Ring-fencing aims to protect core retail services provided by a ring-fenced body (RFB) from risks originating elsewhere in its group and in global financial markets. Nevertheless, the UK's Prudential Regulatory Authority (PRA) has stated that it "does not operate a zero-failure regime, including for RFBs."[1] If the separation of a RFB – organizationally, operationally and financially – is insufficient to prevent failure, resolution would help to ensure continuity in the provision of core banking services.

This approach dovetails with the Bank of England's (BoE) preferred resolution strategy for banking groups subject to ring-fencing – bail-in at the holding company level – with losses generated by an operating company being passed on to the holding company. Hence, if a RFB were to experience losses which depleted its capital, its internal debt (issued to the holding company) would be written down to recapitalize it. This means that the RFB would remain operational and continue to provide core services.

According to the BoE, once in place, around 75% of UK retail deposits will be held within banking groups subject to ring-fencing. Building societies are already restricted to certain business activities under the Building Societies Act 1986 and thus are not subject to ring-fencing.

On a more general note, we would suggest that the ring-fencing structure for large UK banks may be less necessary going forward than it would have appeared to be several years ago, when the Independent Commission on Banking's (ICB) initial proposal was adopted by the government of the time. This is because the much-enhanced prudential and conduct norms for UK banks, alongside the subsequently adopted resolution and recovery framework being applied on a more global scale, have significantly enhanced the safety and sustainability of the UK banking sector compared to the pre-crisis period.

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1 CP 19/14. The implementation of ring-fencing: consultation on legal structure, governance and the continuity of services and facilities. October 2014

Implementation risks

The banking groups subject to ring-fencing have made good progress to-date but we consider that full compliance with requirements is likely to be a complex process entailing execution and operational risks. Amongst other matters, banking groups will need to ensure the financial, operational and management independence of their ring-fenced entities, change internal systems, and move activities, assets and liabilities between various legal entities. The changes will need to be completed sufficiently early in 2018 to allow for a period of transition.

Will debt investors benefit from ring-fencing?

In Scope's view, ring-fencing is intended to benefit retail customers rather than debt investors. Nonetheless, banking groups subject to ring-fencing are likely to be under closer scrutiny and supervision. This added attention may encourage affected banking groups to act in a safer and less risky manner, which would be positive for debt investors.

A RFB remains part of a larger banking group that will continue to be supervised and regulated as a group. In October 2017, the BoE issued a consultation paper following a review of the Groups Policy framework, which reiterates that prudential requirements are set at an individual, ring-fenced and consolidated basis. Although separate requirements, they are meant to be complementary. In addition, a key guiding principle is that consolidated banking groups should have appropriate financial resources to cover the risks of the entire group.

In the BoE's December 2017 supervisory statement on the Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP), there are specific guidelines for avoiding "RFB group risk", the risk that the financial position of a consolidated group may be adversely affected by capital and buffers applicable at the level of the RFB, such that there is insufficient capital within the consolidated group to cover the risks of the entire group.

Debt issued by operating companies

Assessing the implications of ring-fencing on debt issued by current and future operating companies is a bank-specific exercise. Generally, Scope does not take the view that, within the same banking group, debt investors in RFBs are automatically better protected than debt investors in non-ring-fenced entities.

Under the BoE's preferred resolution strategy for groups subject to ring-fencing – bail-in at the holding company level – it is not clear that RFBs would be given preferential treatment. In a situation where an operating company (RFB or not) incurs losses, these would be absorbed in an order following the operating company creditor hierarchy. The write down of internal MREL would recapitalize the operating company and pass on losses to the holding company. Therefore, the operating company would not necessarily face resolution.

This is an extreme scenario and various management and supervisory actions would likely be taken well before an operating company faces such dire circumstances.

Ring-fenced bodies

Scope presumes that future RFBs will be primarily deposit funded. However, they may also issue short-term, senior unsecured debt, and secured debt such as covered bonds. Investors in RFB debt would generally be exposed to a relatively low-risk retail bank, putting aside the potential risks of operating in a single market, the UK.

Non-ring-fenced entities

Non-ring-fenced entities would be involved in international retail banking, corporate banking, capital markets and/or consumer finance activities. The credit profiles of the various non-ring-fenced entities will differ, depending on their specific business models and financial metrics. These entities are likely to have a greater reliance on market funding.

Outstanding securities of current main operating banks

With the implementation of ring-fencing, outstanding debt of current UK main operating banks may be transferred to future non-ring-fenced entities. The credit profiles of these future non-ring-fenced entities are likely be somewhat riskier than the current main operating banks, as the relatively low-risk UK retail business would be removed and placed in RFBs. However, we expect banking groups to continue managing their debt liabilities in a co-ordinated and consistent manner amongst their various issuing entities.

Legacy capital instruments issued by operating companies will no longer count as MREL after 31 December 2021. If they have not matured by then, the UK regulator has said it will work with banks to remove them if they represent a barrier to a resolution strategy.

Rating implications

In the following pages, we look specifically at each of the four banking groups (Barclays, HSBC, Lloyds and RBS). By and large, our analysis focuses on the business model, financial metrics and importance of an operating company to its group rather than on whether it is ring-fenced or not.

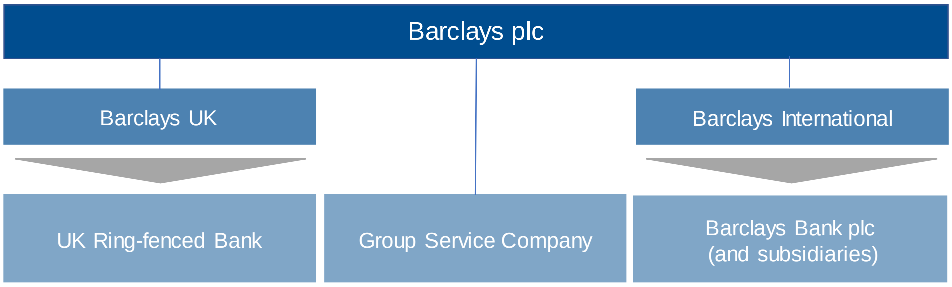
Barclays Bank plc (A+, Stable)

In March 2016, Barclays announced plans to further simplify and prepare the group for ring-fencing requirements. The group's reporting has since focused on two primary divisions: Barclays UK, a UK consumer and business bank; and Barclays International, which comprises corporate and investment banking, consumer, cards, and payments businesses.

Barclays UK will form the newly-created ring-fenced bank and is expected to maintain diversified funding sources – deposits (retail and business banking), term funding (internal MREL from Barclays plc, senior unsecured debt, secured funding such as covered bonds and ABS), and short-term funding.

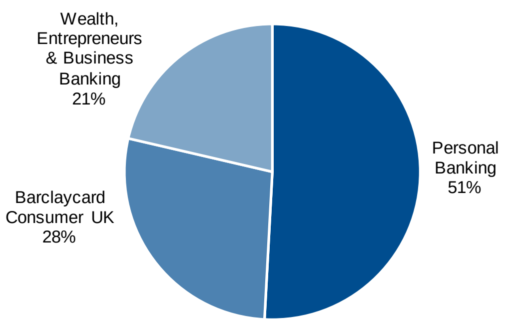
Meanwhile, Barclays International will remain in the existing Barclays Bank plc legal entity and subsidiaries. Funding is expected to come from deposits (corporate, Delaware and international wealth), term funding and capital (internal MREL from Barclays plc, residual outstanding Barclays Bank plc debt, secured funding such as ABS) and short-term funding.

Figure 1: Illustrative future group structure



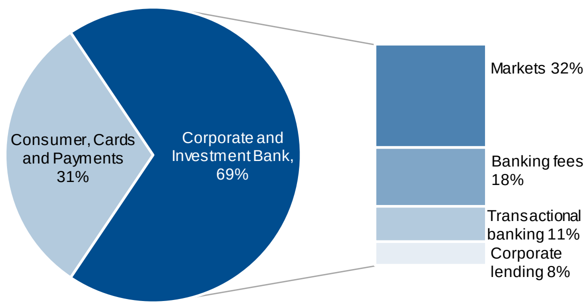
Note: Barclays UK and Barclays International are currently reporting divisions.
Source: Company data, Scope Ratings

Figure 2: Barclays UK revenue breakdown



Notes: Data for 9M 2017. Total revenues of GBP 5.5bn.
Source: Company data, Scope Ratings

Figure 3: Barclays International revenue breakdown



Notes: Data for 9M 2017. Total revenues of GBP 11.1bn.
Source: Company data, Scope Ratings

Figure 4: Barclays UK and Barclays International: Key indicators

	Barclays UK 2016	Barclays UK 9M 2017	Barclays Intl 2016	Barclays Intl 9M 2017
Total revenues (GBP m)	7,517	5,513	14,995	11,063
Profit before tax (GBP m)	1,738	1,295	4,211	3,269
Return on average allocated tangible equity (%)	9.6%	9.4%	9.8%	10.0%
Average allocated tangible equity	8.9	9.0	25.5	28
Loans and advances	166	182	211	221
Customer deposits	189	189	216	241
Risk weighted assets	68	70	213	218
Cost income ratio (%)	65%	66%	63%	62%
Loan loss rate (bps)	52	43	63	67

Source: Company data, Scope Ratings

Implications

Scope currently assigns an Issuer Rating of A+ to Barclays Bank plc based on the credit fundamentals of the entire group, Barclays plc.

With ring-fencing, Barclays Bank plc will comprise the business division currently being reported as Barclays International. In addition, residual outstanding debt issued by Barclays Bank plc will remain with this entity.

As shown in Figure 4, Barclays International comprises about two-thirds of the group's revenues. In terms of business mix, about half the revenues come from investment banking activities (roughly one-third Markets and another 20% in banking fees). We acknowledge the progress that the group has made in right-sizing and de-risking its investment banking activities. The remainder of revenues comes primarily from corporate banking and the profitable consumer cards and payment businesses.

Based on the business mix and available financial indicators of the future Barclays Bank plc, we anticipate maintaining the A+ rating.

Meanwhile, the future RFB will be materially comprised of the currently reported Barclays UK business division. This is primarily a retail and business banking business with a strong competitive position. We anticipate assigning a rating of A+ to the future RFB.

In summary, the ratings are likely to be as follows: Barclays plc at A+, RFB at A+, non-ring-fenced bank (Barclays Bank plc) at A+.

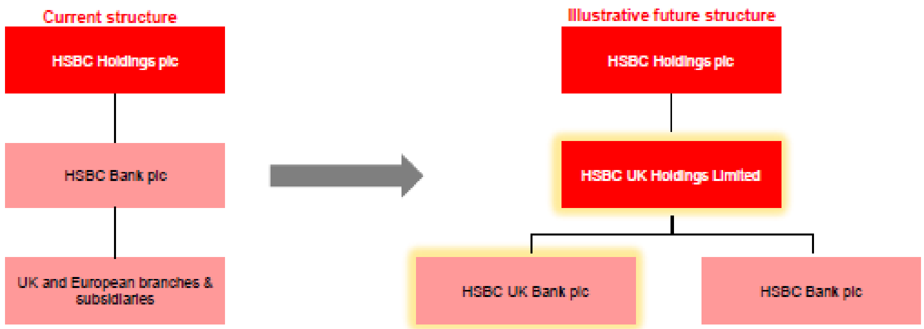
HSBC Holdings plc (AA, Stable)

The group's RFB will be HSBC UK Bank plc, a new entity which will not be a subsidiary of HSBC Bank plc. The RFB will comprise the permitted UK retail banking and wealth management, commercial banking and private banking businesses of the current HSBC Bank plc. Meanwhile, the UK global banking and markets business will remain with HSBC Bank plc.

As of end-2016, UK adjusted revenues, loans and advances, and deposits were USD 12.7bn, USD 264bn, and USD 361bn, respectively – accounting for approximately 25%, 30%, and 28%, respectively of group revenues, group loans and advances, and group deposits.

HSBC Bank plc will remain the issuer under its debt issuance programmes and outstanding securities issued under such programmes will continue to be obligations of HSBC Bank plc.

Figure 5: Current and illustrative future group structure



Notes: HSBC Holdings plc and HSBC UK Holdings Limited are holding companies. The other entities are operating companies. Entities outlined in yellow are new entities.
Source: Company data

Implications

Scope currently assigns an Issuer Rating of AA to HSBC Holdings plc, which acts as the group holding company. The rating is based on the credit fundamentals of the group in its entirety; a highly diversified business in terms of activity and geography with a unique market position.

With ring-fencing, the profile of HSBC Bank plc will change as it will no longer contain the UK retail, commercial and private banking businesses. The future HSBC Bank plc will contain UK and European global banking and markets businesses as well as European branches and subsidiaries. Major European subsidiaries include HSBC France, HSBC Germany, and HSBC International (Jersey). Outstanding debt of HSBC Bank plc will remain with this entity.

Meanwhile, the RFB, HSBC UK Bank plc, will be a domestic retail and commercial banking business with a strong competitive position.

We expect both the RFB and the future HSBC Bank plc to be important operating companies of the group, benefiting from strong group management. We anticipate a rating of AA for both entities, in line with the rating on the group.

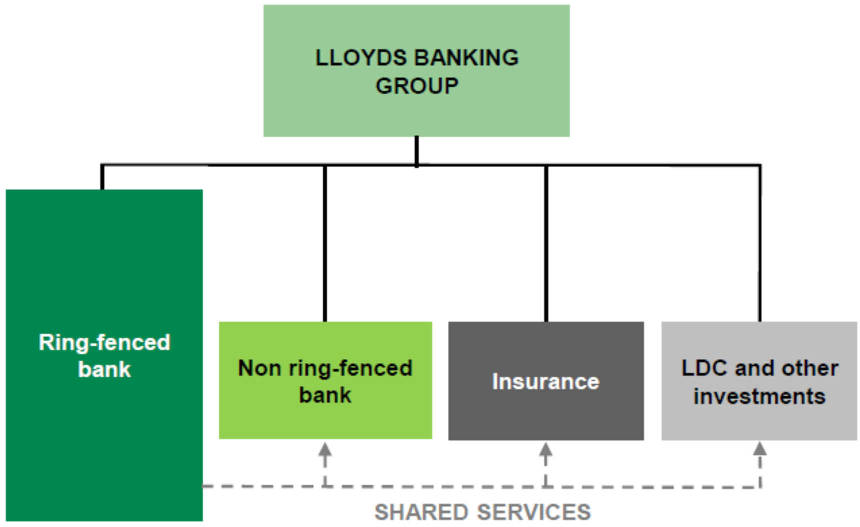
In summary, the ratings are likely to be as follows: HSBC Holdings plc at AA, RFB (HSBC UK Bank plc) at AA, and non-ring-fenced bank (HSBC Bank plc) at AA.

Lloyds Bank plc (A+, Stable)

The group has established a non-ring-fenced bank, Lloyds Bank Corporate Markets plc (LBCM), which will contain approximately 3% of the group's loans and advances and approximately 7% of the group's RWAs. LBCM will be primarily comprised of Commercial Banking Markets Financing (including loan markets, bonds and asset securitization), Commercial Banking Financial Markets Products (including FX and rates), the business of Lloyds Bank International Ltd and the group's branches in the United States, Singapore and Crown Dependencies.

Being primarily a UK retail and commercial bank, the bulk of the group will comprise the RFB. As is the case currently, the group's insurance business will operate as a separate entity.

Figure 6: Illustrative future group structure



Note: LDC is Lloyds Development Capital and is involved in private equity.
Source: Company data

Implications

Scope currently assigns an Issuer Rating of A+ to Lloyds Bank plc based on the credit fundamentals of the entire group, Lloyds Banking Group plc.

As the RFB will comprise the bulk of the current Lloyds Bank plc, we anticipate maintaining the rating of A+. While we will not in a first stage assign a rating to the non-ring-fenced bank (Lloyds Bank Corporate Markets plc), we could envision a slightly lower rating than for the RFB. The non-ring-fenced bank would be primarily a commercial banking and markets-related business, accounting for only a minor proportion of the group.

In summary, the ratings are likely to be as follows: Lloyds Banking Group Plc at A+ and the RFB (Lloyds Bank Plc) at A+.

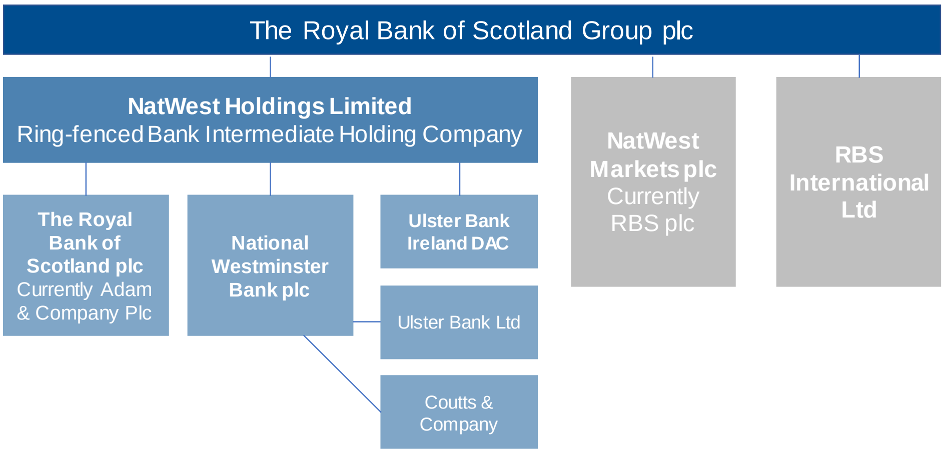
The Royal Bank of Scotland plc (A-, Stable)

Based on its future business profile and excluding RBS Capital Resolution (non-core assets), approximately 80% of the group's RWAs will be ring-fenced. Under a ring-fenced bank intermediate holding company, there will be three major operating entities: The Royal Bank of Scotland plc, National Westminster Bank plc and Ulster Bank Ireland DAC. The ring-fence will include the group's personal, private, business and commercial customers in Scotland, England, Wales, Ireland, and Western Europe. Businesses within the ring-fence are expected to be primarily deposit-funded, with access to wholesale markets and MREL downstreamed from the group holding company, The Royal Bank of Scotland Group plc.

In addition, there will be two non-ring-fenced entities: NatWest Markets plc (about 15% of group RWAs) and RBS International Ltd. (about 5% of group RWAs). NatWest Markets plc will contain corporate and investment banking businesses while RBS International Ltd will comprise retail and commercial banking activities in the Crown Dependencies and Gibraltar (non-EEA). NatWest Markets is expected to have access to wholesale markets, repo funding and MREL downstreamed from the group holding company. Meanwhile, RBS International Ltd is expected to be primarily deposit-funded but also have access to wholesale markets.

The group's existing covered bond programme will be transferred to the RFB while all other external debt will remain with the respective original issuing entities.

Figure 7: Illustrative future group structure



Notes: Adam & Company is a subsidiary of the group serving private banking clients. In mid-2018, Adam & Company will be renamed after receiving most of the existing personal, private, business and commercial customers from the Royal Bank of Scotland plc. Further, The Royal Bank of Scotland plc will be renamed NatWest Markets plc.

Source: Company data, Scope Ratings

Implications

Scope currently assigns an Issuer Rating of A- to The Royal Bank of Scotland plc based on the credit fundamentals of the entire group, The Royal Bank of Scotland Group plc. In addition, the rating includes one notch of rating uplift due to the UK government's majority ownership.

As it will contain the core retail and commercial banking businesses of the group, we anticipate assigning a rating of A- to the ring-fenced bank intermediate holding company, NatWest Holdings Limited.

Due to their business profiles and their lesser significance to the group, we envision the two non-ring-fenced entities (NatWest Markets plc and RBS International Ltd.) having slightly lower ratings than for the RFBs.

In summary, the ratings are likely to be as follows: The Royal Bank of Scotland Group plc at A-, the ring-fenced bank intermediate holding company (NatWest Holdings Limited) at A-, and the non-ring-fenced bank (NatWest Markets plc) at BBB+.

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