UK Bank Ring-fencing: Implications for Banks and Investors

Based on recommendations from the Independent Commission on Banking (ICB) established at the height of the financial crisis, in 2013 the UK government passed legislation on the need for domestic retail banking activities of large banking groups to be ring-fenced from the rest of their activities, notably from wholesale and investment banking. The aim was to ensure that ring-fenced bodies (RFBs) are protected from shocks originating from the rest of their banking group or the financial system in general in order to minimise disruption to the provision of core services in the UK – retail deposit taking and payment activities. In addition, RFBs, and groups containing RFBs, should be resolved in an orderly manner with minimal disruption to the provision of core services.

Scope believes that while the objectives appear sensible, ring-fencing does raise issues for both banks and investors. In addition to the costs of implementation, there are operational and execution risks. The changes will impact customers and banks will need to manage this without impairing service levels and customer satisfaction.

Further, there will be implications for both funding and capital, particularly how best to fund various group entities. The level of funding costs will depend to some degree on whether investors understand where they are positioned within the creditor hierarchy. Inevitably, the period of repositioning and transition will be more complex than the final end-state.

At this time, the necessity of implementing significant structural transformation such as ring-fencing could be questioned, especially in light of other regulatory reforms, particularly resolution and recovery, which are being applied on a more global footprint. As ring-fencing will come into force from January 2019, the relatively generous timing as well as the UK PRA's outcomes-based approach, should provide the affected banks with some flexibility to meet requirements.

Only in certain areas such as legal structure, governance, prudential requirements and intragroup arrangements is the PRA being more prescriptive. By mid-2016 the PRA plans to publish final rules and supervisory statements. Meanwhile, by end-January 2016, banks are expected to submit their near-final plans for implementation.

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Issues raised by ring-fencing

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Execution risks

For banks, there are one-off and ongoing costs involved in reorganising their group structures to comply with the ring-fencing rules. Depending on what goes in the RFB, there can be implications for how banks meet customer needs. A customer may require more services than provided by the RFB. How does a bank ensure that the customer's needs are met effectively and without negatively impacting the customer experience?

Setting up RFBs will entail implementation and operational risks. Adapting IT systems, the novation of contracts with customers and service providers as well as employee and pension arrangements are just some of the issues that will need to be dealt with. Some banks have said that their RFBs will run in parallel in 2018, well before the effective date to ensure that potential problems are worked out.

Funding costs

Within a banking group, there will be a RFB and potentially one or more non-RFBs. What will be the credit profiles of the various entities? This will have implications for how the various entities fund themselves and the cost of funding. As a RFB's exposures to other group members will be treated as third parties this limits the ability of the businesses within a RFB to cross-fund other activities within the group. Further, the proposals do not permit intragroup liquidity concessions between RFBs and non-RFBs. This could lead to funding inefficiencies and higher funding costs.

Banking groups may also incur increased costs due to the need to raise additional capital. As RFBs will be subject to individual prudential requirements, including Pillar 2 capital requirements this could impact a bank's overall capital requirements. In addition, the PRA does not expect UK parents of RFBs to use double leverage to fund investments in their RFBs. Again, this may entail more CET1 capital at group level.

Funding at the holding company level and then down-streaming internally may partially address the issue. This, however, is complicated by the fact that currently many UK banks maintain the bulk of their debt outstanding at the operating company level. As this debt matures, some have said that they intend to refinance from the holding company – not an insignificant exercise to execute. In the meantime, investors are concerned about the quality and ranking of the debt they currently hold as it may be supported by a smaller and potentially less stable source of earnings.

Competition matters

The PRA has said that its approach aims to preserve to the extent possible the benefits of RFBs being part of a wider group. While other group members should be treated as third parties, the cross-selling of products and services and correspondent banking and agency arrangements between a RFB and other entities in its group are not restricted. At the same time, RFBs should not become dependent on income which is generated directly from transactions with other group members or from shared customer relationships – i.e. a RFB would be unable to perform core activities if such income were lost or significantly reduced.

The costs associated with ring-fencing, in particular the cost of funding, may impact the pricing of both retail and wholesale products and services. Due to the competitive environment, banks may not be able to pass on these costs to customers. In particular, RFBs will not be able to undertake certain investment banking activities. With the limits on intragroup exposures these activities may face higher costs leading to funding inefficiencies and potentially increased levels of wholesale funding from external sources.

More generally, does ring-fencing place UK banks at a disadvantage to global peers? It appears that in the US and Europe the structural reforms that banks must make are less onerous. Consequently UK banks subject to ring-fencing may face greater competitive challenges as well as increased costs. Smaller players in the UK domestic banking market, both domestic and foreign, will not be subject to the ring-fencing rules.

In the US, the Volcker rule which became effective from April 2014 generally prohibits a banking entity from engaging in proprietary trading while certain trading and fund activities are expressly permitted – notably, underwriting activities, market making-related activities, and risk-mitigating hedging activities. Meanwhile in Europe, authorities are still deciding on their approach to structural reform but the issue does not appear to be a priority. The Liikanen report published in 2012 and which had recommended a milder form of ring-fencing, seems for the time being to have been put on a back burner.

Ring-fencing requirements

In regards to ring-fencing the PRA has taken an approach of articulating outcomes that it expects but generally has not dictated how banks should achieve them. Only in certain areas has the PRA been more prescriptive. We further note that the PRA is following a proportionate approach in light of the heterogeneous nature of the banks to which ring-fencing requirements will apply. Consequently, the PRA has said that it will consider requests from banks to waive or modify rules if appropriate.

The PRA seeks to ensure the continuity of core services by focusing on the resilience of a RFB to certain risks and by implementing ring-fencing in such a way that facilitates orderly resolution. More specifically, the rules aim to ensure that a RFB's core activities are not adversely impacted by the acts or omissions of other members of the group, the RFB is able to make independent decisions, does not depend on resources provided by a member of the group which would cease to be available if the other member were insolvent and that the RFB would be able to carry out its core activities in the event of insolvency of one or more members of its group. Near-final rules and supervisory statements regarding legal structure, governance and the continuity of services and facilities were published in May 2015 (see below for more details).

In October 2015, the PRA published further consultation papers on the issues of prudential requirements, intragroup arrangements, the use of financial market infrastructures and ensuring operational continuity in resolution. These proposals focus on the financial resilience of RFBs and the relationship of a RFB with other group entities as well as with other third parties. Again the aim is to ensure that RFBs are resilient to shocks that may disrupt the provision of core services and that RFBs are sufficiently insulated from the acts or omissions of other group members.

The latest consultation paper proposes that RFBs be subject to individual prudential requirements including Pillar 2 capital requirements, capital buffers and liquidity and funding requirements. As long as capital requirements are met and the PRA has been notified, RFBs may make distributions to group entities, including dividends. Recognising that RFBs will enter in various transactions with group entities, including commercial relationships, the PRA further proposes that RFBs act at "arm's length" and treat exposures and transactions with group members as third parties. RFBs should limit exposures to group entities to 25% of eligible capital. Further, RFBs will have reporting requirements and must demonstrate to the PRA that they are complying with ring-fencing obligations.

Legal structure

RFBs should not own entities which conduct excluded or prohibited activities. In addition, RFBs should not be owned by such firms to ensure that the RFB makes decisions independently. The PRA expects that banking groups will adopt a "sibling structure". RFBs and entities that conduct excluded or prohibited activities are expected to be structured as separate clusters of subsidiaries beneath a UK holding company.

For banking groups subject to ring-fencing, the preferred resolution strategy is bail-in at the holding company level. Bail-in would recapitalise the relevant operating entity (an RFB or other member of the group) by passing losses generated by the operating entity up to the holding company. The group should stabilise, allowing the RFB to continue providing critical services. Resolution at the holding company level should also avoid the need to separate the RFB from the rest of the group.

Governance

The rules concerning governance, risk management, internal audit, remuneration and human resources policy are intended to ensure that RFBs make decisions and devise strategies independently of other group members. There are specific rules regarding the members of the RFB's board. In addition, the RFB should have sufficient representation on the parent's board.

Importantly, when a RFB is part of a wider group it will remain a subsidiary and therefore the parent company will still be expected to exercise adequate oversight of the RFB. However, parent company actions should not cause a RFB to act in a way that is inconsistent with ring-fencing obligations.

Continuity of services and facilities

Ring-fencing should ensure that a RFB can continue to perform core activities regardless of the acts, omissions or insolvency of other group members. Specific restrictions are imposed on service arrangements that a RFB may have although RFBs are allowed to receive transactional services by group services entities, i.e. services that can be fully represented in contractual terms.

Preliminary proposals by banks

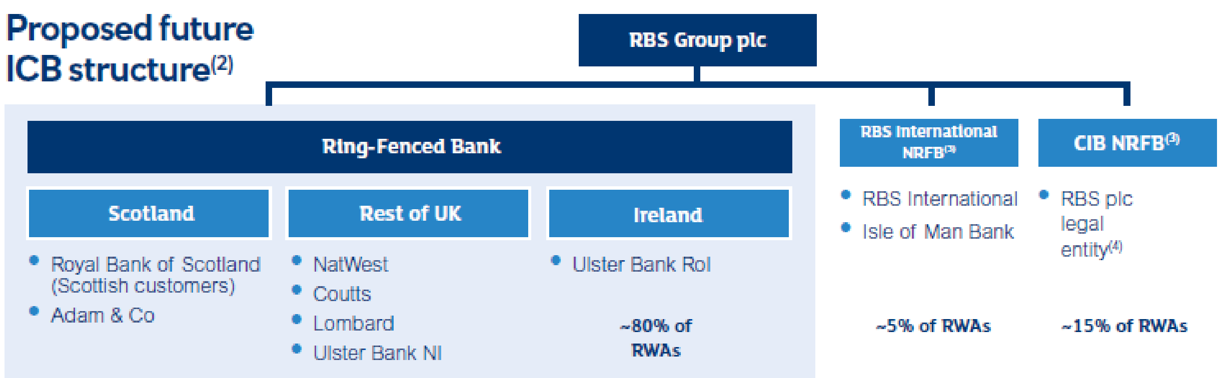
While there may be questions about the necessity, ring-fencing goes into effect on 1 January 2019 in the UK. At this time, ring-fencing is expected to concern six banking groups. The affected banks submitted preliminary plans of their anticipated legal and operating structures in January 2015 to the PRA which have been reviewed. After publication of the latest consultation papers, the banks are now expected to provide near-final plans by end-January 2016. Based on the information provided by the four banks that we rate (Barclays, HSBC, Lloyds and RBS) we note the variety in approach – driven by the banks' business models.

The most straight-forward scenario appears to be the situation with **Lloyds** as management believes that it would operate practically as a RFB with most of the group being in the ring-fence.

HSBC has proposed establishing a service company to support ring-fenced and non-ring-fenced banking activities. This service company would be bankruptcy remote and would be capitalised at a level consistent with the group. The envisioned RFB would be broad-based and incorporate the four various businesses of the group. As well, the RFB will operate under a new brand name and be based in Birmingham.

RBS has proposed a RFB that would comprise about 80% of RWAs and contain operations in Scotland, the rest of the UK and Ireland (see Figure 1). In addition, there would be two non-RFBs – RBS International (about 5% of RWAs) and CIB (about 15% of RWAs). The non-ring-fenced CIB would comprise the legal entity RBS plc and hold the Markets business (rates, currencies, DCM), some corporate activity and the US broker-dealer, RBS Securities. Management has stated that future debt issuance will be primarily at the holding company level, RBS Group plc. As of year-end 2014, the group had about GBP 76bn in outstanding debt. Post 2019, RBS has said that GBP 4.3bn of senior and GBP 1.7bn of subordinated debt would remain at RBS plc which is not a ring-fenced entity.

Figure 1: RBS's proposed structure

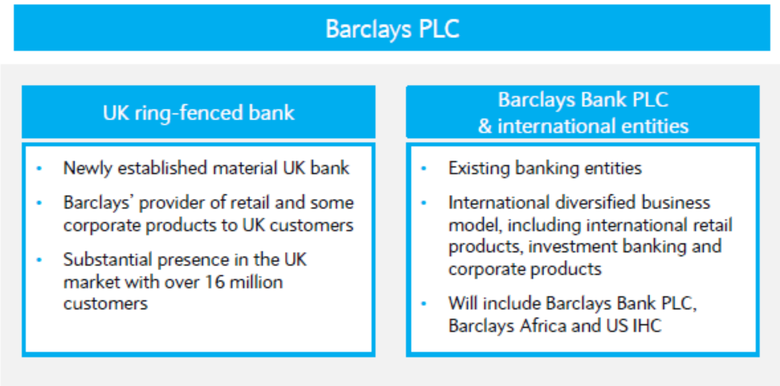


Source: Company data
Notes:(2) Preliminary plan submitted to PRA on 6 January 2015; subject to further amendment.
(3) Non-Ring-Fenced Bank

Barclays is proposing a somewhat different structure driven by an expressed desire to maintain the "financial robustness of all parts of the group" (see Figure 2). Under the holding company, Barclays plc, there would be a newly established RFB providing retail and some corporate products to UK customers. In addition, there would be a non-RFB including Barclays Bank plc, Barclays Africa and the US intermediate holding company (primarily the broker-dealer Barclays Capital and Barclays Bank Delaware which holds the cards business). This non-RFB would have an internationally diversified business model, including international retail products, investment banking and corporate products.

The group has emphasised that post structural reform, diversification is expected to be maintained at the holding company level, with Barclays plc continuing to issue AT1 and Tier 2 capital. In addition, over time senior unsecured debt currently at Barclays Bank plc will be refinanced out of the holding company. Meanwhile, Barclays Bank plc and other operating subsidiaries are expected to meet their capital and term senior unsecured funding needs largely through internal TLAC. Barclays Bank plc will however continue to issue short-term wholesale funding (e.g. CDs, CPs and ABCPs).

Figure 2: Barclays' proposed structure



Source: Company data

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