Linklaters

Independent Commission on Banking
Final Report on UK Banking Reform

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1. Introduction

The UK Independent Commission on Banking (the "**ICB**") published its final report on 12 September 2011.

The recommendations contained in the final report (which build on themes contained in the ICB's interim report from April 2011 (click here to read our related briefing note)) aim to create a more stable and competitive UK banking industry.

The possible nature and extent of the ICB's final proposals has generated significant interest within the UK banking industry as, although not legally binding, they are likely to have a significant influence on the direction of future regulation in the UK.

The final report contains a significant number of proposals on a broad range of issues. This briefing note summarises some of the ICB's key recommendations.

2. Ring-fence

The ICB's interim report identified a need to introduce some form of segregation between what might broadly be described as retail and investment banking activities. To this end, it considered varying degrees of structural reform, in particular full segregation into separate entities coupled with restrictions on cross-ownership, and, as an alternative, retail operations being confined to a dedicated subsidiary within the wider group. Although the ICB's final report recommends the more moderate option of a dedicated entity within the larger group, it contains a significant number of proposals designed to ensure that this form of ring-fencing is robust. The ICB's recommendations on structural reform include the following proposals:

> **Separate legal entity** – The ring-fenced entity should constitute a separate legal entity;

> **Activities which must be within ring-fence** – Activities which may only be conducted within the ring-fenced entity include the taking of deposits from, and the provision of overdrafts to, individuals and small to medium-sized organisations located in the UK;

> **Activities prohibited within ring-fence** – Activities which may only be conducted outside the ring-fenced entity include the purchase or origination of derivatives or other contracts resulting in a requirement to hold capital against counterparty risk, the purchase of loans or securities in the secondary markets and any activities which would result in the holding of trading book assets or a requirement to hold capital against market risk;

> **Activities which may occur within ring-fence** – Activities which may, but do not have to, be conducted within the ring-fence include those which are ancillary to the primary activities conducted by the ring-fenced entity, are required for the provision of the ring-fenced services and do not constitute a separate line of business. Examples of permitted ancillary services would include employing staff, owning or procuring the necessary operational infrastructure for the ring-fenced entity and financial activities to the extent that these are strictly required for the purposes of the ring-fenced entity's treasury function (such as raising funding or interest rate hedging). In addition, ring-fenced entities may also engage in any other activity which is not prohibited from being conducted inside the ring-fence, for example the provision of straight-forward services (such as deposit-taking and lending) to European Economic Area ("**EEA**") individuals and non-financial EEA companies;

> **Summary impact** – Under the ICB's proposals, the activities confined to the ring-fenced entity are not purely retail in nature and, consistent with the UK's treaty obligations, may include services to persons within the EEA. In this sense, the description of the ICB's proposals as the creation of a "UK retail ring-fence" is somewhat inaccurate and the ICB has, to some extent, accommodated the banks by allowing them the flexibility to conduct a wider set of activities within the ring-fenced entity;

> **Self-sufficiency and dividend restrictions** – The ring-fenced entity should be able to meet regulatory requirements on capital, large exposures, liquidity and funding on a stand-alone basis (and, as an operational matter, should be a direct member of all relevant payment systems or have access to them through another ring-fenced entity). One consequence of this would be that, under the large exposures regime, a ring-fenced entity could generally not incur an exposure to another member of its group which is greater than 25% of its capital resources. Any failure to meet regulatory requirements on a self-sufficient basis would result in restrictions on the ring-fenced entity being able to pay dividends without consent from its regulator;

> **Operational** – The ring-fenced entity's wider corporate group must have arrangements in place whereby the ring-fenced entity has continuous access to all of the operations, staff, data and services required to continue its activities, even where the wider corporate group is in financial difficulties. This may result in these services being provided by bankruptcy-remote vehicles;

> **Intra-group transactions** – All transactions between the ring-fenced entity and other members of its group must be conducted on arm's length terms and should not be treated more favourably for regulatory purposes than third party transactions;

> **Reporting** – The ring-fenced entity should be required to make all disclosures that would be required if it were independently listed on the London Stock Exchange; and

> **Independent governance** – Except in cases where the vast majority of the group's assets are within the ring-fenced entity, the board of the ring-fenced bank should be independent, be comprised of a majority of non-executive directors (only one of whom may sit on the board of the ring-fenced entity's parent or another member of its group). The board of the ring-fenced entity should also have a duty to maintain the integrity of the ring-fence at all times.

3. Capital and loss absorbency

The ICB's interim report considered a requirement whereby UK retail banking subsidiaries and systemically important financial institutions should hold equity capital of at least 10% of risk-weighted assets ("**RWAs**"). This would have been 3% higher than under the Basel III proposals. The ICB's final report introduces a number of recommendations on the nature and quantity of capital to be held by large institutions, some of which apply generally, some only to the ring-fenced retail entities and some to both. These include:

> **Equity** – Ring-fenced entities having a ratio of RWAs to UK gross domestic product ("**UK GDP**") of 1% or more should maintain an equity to RWAs ratio of at least 7% (with that equity ratio increasing on a sliding-scale to 10% for ring-fenced entities having a ratio of RWAs to UK GDP of 3% or more). The ICB expects that this calibration would mean that the ring-fenced entities within the Barclays, HSBC, Lloyds Banking Group, Nationwide, RBS and Santander groups would all need to meet the 10% requirement;

> **Primary loss absorbing capacity** – UK-headquartered globally systemic important banks ("**G-SIBs**") allocated a surcharge of 2.5% under the Basel III proposals, and ring-fenced entities with an RWA to UK GDP ratio of 3% or more, should be required to have "primary loss-absorbing capacity" (consisting of equity, non-equity capital and bail-in bonds with a remaining maturity of at least 12 months) of at least 17% of RWAs (with this reducing on a sliding-scale down to 10.5% for smaller G-SIBs and ring-fenced entities). This represents a significant increase relative to the Basel III proposals, but the ICB believes that it is justified on the basis that it would have been sufficient to absorb the losses suffered by nearly all the loss-making banks in the recent financial crisis;

> **Resolution buffer** – Supervisory authorities should have the power to require any G-SIB, or ring-fenced entity with an RWA to UK GDP ratio of 1% or more, to have up to an additional 3% of primary loss-absorbing capacity if the supervisory authorities have concerns that such entities cannot be resolved at minimum risk to the public purse. This discretion would extend to the form of capital to be held and its location within the group. The ICB recommends that the size and composition of this buffer should be assessed in light of factors such as the bank's complexity, its contribution to systemic risk and the level of risk it presents to the UK tax payer in resolution;

- **Interaction with CRD IV** – The ICB's recommendations that ring-fenced entities should maintain an equity to RWAs ratio of up to 10% is not too far removed from the figure of up to 9.5% reached by aggregating (i) the Basel III proposals that banks hold 7% of RWAs as common equity with (ii) the Basel III proposals that G-SIBs hold a further 2.5% of additional common equity. However, the requirement for G-SIBs and large ring-fenced entities to have primary loss absorbing capacity of up to 17% (or 20% if the resolution buffer is included) represents a significant bolstering of the position under Basel III. It will be interesting to see the extent to which these recommendations will prove to be compatible with the draft European legislation on prudential regulation which is due to implement the Basel III proposals ("**CRD IV**"). The CRD IV provisions on capital require banks to hold 7% of RWAs as common equity (plus up to 3.5% of RWAs as further capital in other forms), and the use of a Regulation to impose these provisions (which becomes law without the need for member states to pass implementing legislation) is intended to prevent member states from "gold-plating" capital requirements by imposing higher standards under domestic law than those contained in CRD IV;
- **Leverage ratios** – All UK-headquartered banks and ring-fenced entities should maintain a Tier 1 leverage ratio of at least 3%. The leverage ratio would increase on a sliding scale in the case of ring-fenced entities with a ratio of RWAs to UK GDP in excess of 1% with the ratio increasing up to 4.06% for ring-fenced entities with a ratio of RWAs to UK GDP of 3% or more;
- **Creditor loss absorption ("bail-in")** – During bank resolution proceedings, supervisory authorities should have a primary power to impose losses on unsecured long-term debt of UK banks (with debt being defined as long-term for these purposes if it has an original maturity of 12 months or more). The ICB recommends that the debt instruments which are subject to this power should contain specific disclosures acknowledging this risk and that debt instruments governed by laws other than English law should, to the extent possible, contain contractual provisions giving effect to this power. The ICB also recommends that supervisory authorities should have a secondary power, where necessary, to impose losses on all liabilities which are either unsecured or secured by floating

charges[1] (although the ICB's final report is silent as to any requirement to incorporate risk disclosures or contractual provisions in respect of this secondary power). The ICB considers that no form of grandfathering for existing liabilities is necessary; and

> **Depositor priority** – During insolvency and resolution proceedings, all depositors who benefit from the Financial Services Compensation Scheme should rank ahead of unsecured creditors and creditors secured by floating charges.

4. Competition

The key competition matters contemplated by the ICB's interim report included a possible increase in the divestiture requirements imposed on Lloyds Banking Group ("**LBG**") beyond those settled in November 2009, a facilitation of retail customers' ability to switch current accounts and a clear mandate for the Financial Conduct Authority (the "**FCA**") to promote effective competition within the UK banking industry. These proposals remain the focus of the ICB's recommendations in its final report, which include the following:

> **LBG divestiture** – The Government should reach agreement with LBG that the entity resulting from the divestiture agreed between LBG and the European Commission in 2009 has a funding position at least as strong as its peers (measured using a loan to deposit ratio at the time of divestiture) and has at least a 6% share of the personal current account market;

> **Barriers to entry** – The Prudential Regulatory Authority and the Office of Fair Trading (the "**OFT**") should review the application of prudential regulation standards and ensure that capital and liquidity requirements (in particular the increased costs of using the more advanced risk assessment techniques which can allow reduced holdings of capital) do not act as a barrier to entry and growth of new participants;

> **Current account switching** – Customers should be provided with a free and improved account switching service (which the ICB suggests should be fully operational by September 2013) whereby all standing debit and credit arrangements are automatically transitioned to new accounts so that customers are protected against any risks inherent in this process (such as administrative errors causing missed payments);

[1] It is unclear whether this will be compatible with the Government's obligations under the Financial Collateral Directive.

> **Product transparency** – Banks should provide their retail and business current account customers with greater transparency on account terms (including details of any interest foregone relative to the Bank of England base rate) by January 2013 in order to enable customers to make an informed choice between potential service providers. More generally, the OFT and FCA should work with the banks to improve transparency across all retail products; and

> **Future competition investigation** – A reference to the Competition Commission for independent investigation has been suggested by 2015 at the earliest, if one or more of the key improvements in banking markets (namely the emergence of a strong and effective challenger from the LBG divestiture, considerable improvement of the current account switching process and the establishment of a pro-competitive FCA) has not materialised and the OFT has not already made a reference following its proposed 2012 review of the personal current account market.

5. Timetable

The ICB's final report recognises that a full implementation of its proposals would present significant challenges both to the Government and the UK banking industry.

In order to allow time for the Government to assess the ICB's proposals, and in recognition of the adverse consequences that an accelerated implementation timetable could have in a weak economic environment, the ICB proposes that its recommendations on structural reform, capital and loss-absorbency should be implemented by no later than early 2019 (in line with the Basel III implementation timetable).

The Government has subsequently endorsed the content of the ICB's final report and its proposed implementation timetable.

6. US comparison

The ICB's final report makes many recommendations that have a rough equivalent in the historic bank regulatory regime in the United States. Depositor preference, the separation of retail and investment banking, restrictions on transactions between the retail bank and its affiliates – all of these broadly would appear to align the UK retail banking sector more closely with the regulatory regime to which US banks are already subject. Nevertheless, there are several meaningful points of departure between the ICB proposals and the US rules that are likely to be the subject of intense focus by banks on both sides of the Atlantic.

Even if the ICB's ring-fencing proposal is adopted, US banks will still be subject to considerably more restrictive limits than their UK counterparts on their ability freely to use bank deposits to fund their non-bank affiliates. US law has long subjected insured banks both to an overall cap on extensions of credit to affiliates and to a requirement that any credit to affiliates must be fully secured by cash or other high-quality collateral. The ICB's proposal that these transactions be on arm's length is, as a practical matter, considerably less restrictive than the US rules. Equally, the ICB's proposals would preclude a UK retail bank from engaging in proprietary trading but permit trading outside the ring-fence. Under the Volcker Rule provisions of the Dodd-Frank Act, US banks and their affiliates will be similarly restricted. On the other hand, US banks are broadly able to conduct a much wider range of activities (including secondary loan sales and most derivatives activities) within the insured bank than would be the case for ring-fenced retail entities under the ICB's proposals.

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