Bank Insolvency:

The introduction of ring-fencing in the UK: an example to be followed?

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Introduction

It is now just over a decade since the beginning of the financial crisis that started with the failure of UK bank Northern Rock and which went on to beset much of the globe. The last ten years have seen an enormous amount of international effort directed at identifying policies that will prevent a similar crisis from occurring in the future and in enacting legislation that will achieve this goal and, ultimately, protect the taxpayer from bearing the costs of cross-border bank failure[1] that result from the problem of "too big to fail".[2] Within the UK, one of these policies has been to introduce ring-fencing

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[1] Within the UK and the EU these have included the UK's 2008 Banking (Special Provisions) Act (emergency legislation to introduce an insolvency regime for Northern Rock) and 2009 Banking Act (a new insolvency regime for failing banks); the EU's 2009/14/EC Deposit Guarantee Scheme Directive [2009] OJ L68/3 (which increased the depositor protection limit across the EU); the UK's 2012 Financial Services Act (which replaced the Financial Services Authority as regulator with the Prudential Regulation Authority (the Bank of England) and the Financial Conduct Authority); the EU's 2013 CRD IV (EU/575/2013 Capital Requirements Regulation [2013] OJ L176/1 and 2013/36/EU Capital Requirements Directive [2013] OJ L176/388) (which introduced Basel III to improve prudential requirements for banks); the UK's 2013 Financial Services (Banking Reform) Act (to introduce ring-fencing); as well as the EU's 2014/59/EU Bank Recovery and Resolution Directive [2014] OJ 2 173/190 (the "BRRD" which seeks to standardise the EU approach to bank resolution, introducing pre-agreed plans, crisis management groups and bail in), EU/806/2014 Single Resolution Mechanism [2014] OJ 2 225/1 (the "SRM" which provides a centralised approach to cross-border bank failure within the Eurozone) and the 2014/49/EU Recast Deposit Guarantee Scheme Directive [2014] OJ 2 173/149 (the "DGSD"). The US saw the enactment of Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act Pub L No 11-203, tit II, 124 Stat 1326 (2010) (the "Dodd-Frank Act").

[2] ("TBTF") whereby a global systemically important bank or financial institution ("G-SIB" or "G-SIFI") has to be supported with government funds because its failure would cause contagion of the financial system as a whole and so trigger the failure of other banks and financial institutions with serious consequences for the global economy.

(otherwise known as structural separation) for deposit-taking banks.[3] This is, essentially, the separation of retail banking from wholesale and investment banking within an otherwise "universal" bank with the aim of reducing the risks to which the retail banking arm is exposed.

Yet this measure has not been adopted universally. It has been considered in detail but not adopted by the EU[4] and it has been actively rejected in Australia.[5] In the US, a form of ring-fencing was introduced in the Dodd-Frank Act through the Volcker Rule,[6] but this is now being affected by the political situation as President Trump has stated that he wants to repeal the Dodd-Frank Act.[7] Thus it may be the case that the position in the US becomes quite different.

As the UK arrangements for ring-fencing went "live" in 2018 ahead of their formal introduction in January 2019, it makes sense critically

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[3] Through the Financial Services (Banking Reform) Act 2013 ("FSBRA 2013") which amends the Financial Services and Markets Act 2000 to incorporate the ring-fencing provisions.

[4] Ring-fencing was extensively discussed in the Liikanen Report: Erkki Liikanen *Final Report of the High-level Expert Group on reforming the structure of the EU banking sector* Brussels, October (2012). This led to an EU proposal for structural separation: *Proposal for a Regulation of the European Parliament and of the Council on structural measures improving the resilience of EU credit institutions* Brussels, 29.1.2014 COM (2014) 43 final 2014/0020 (COD). The Proposal was rejected by the Committee on Economic and Monetary Affairs on 26 May 2015 ECON_PV (2015) 0527_1 available at: http://www.europarl.europa.eu (accessed 6 September 2015). On 19 June 2015 the European Council agreed its position but is waiting for the EU Parliament to respond. See Press Release 474/15 available at http://www.consilium.europa.eu/en/press/press-releases/2015/06/19-restructuring-risky-banks-council-agrees-negotiating-stances accessed 4 January 2018.

[5] The Australian Financial Systems Inquiry concluded that other prudential improvements, such as increasing capital requirements, would make ring-fencing unnecessary and that the focus of Australia's financial system should be on aligning itself with best international practice. See the Australian Government (The Treasury) Financial Systems Inquiry *Themes of Report: Resilience*. Available at: http://fsi.gov.au/publications/final-report/overview/themes-of-this-report (accessed 3 January 2018). This approach was subsequently affirmed by the Australian Government in its *Response of the Australian Government to the Financial Systems Inquiry* 19 October 2015. Available at: https://treasury.gov.au/publication/government-response-to-the-financial-system-inquiry/resilience-measures (accessed 3 January 2018).

[6] §619 Dodd-Frank Act (US) (n 1).

[7] See, for example, CNN 'President Trump is taking steps to keep his word to "do a big number" on the 2010 Dodd-Frank financial reform law' <http://money.cnn.com/2017/04/21/news/trump-executive-order-taxes/index.html> (accessed 4 January 2018), Donald J Trump *Presidential Executive Order on Core Principles for Regulating the US Financial System* 3 February 2017 and Tom Young 'Trump's proposed Dodd-Frank rollback unpicked' International Financial Law Review, 02626969, 3/6/2017.

to reflect upon what, if anything, this measure adds to the totality of the reforms to the financial sector safety net that have evolved in response to the crisis and consider whether it can be considered a necessary and/or useful initiative. The impact of this paper will be derived first, from its role in contributing to the ongoing global debate on this topic;[8] second, from its contribution to the wider EU discussion of the adequacy of existing EU financial stability measures, including its depositor protection arrangements; and third, from its analysis of the specific question as to whether UK-style ring-fencing should be introduced by the EU to enhance the current EU depositor protection framework that is in place.

The first part of this paper will introduce the authors' central thesis, namely, that ring-fencing has a role to play in enhancing depositor protection where depositors do not trust governments to honour their deposit guarantee schemes, but that beyond this, it may serve to add little of real value to financial stability. The paper will then put this into context, with part two considering the definition of ring-fencing as a financial regulatory concept, as posited by Schwarcz,[9] before analysing the form of ring-fencing that is being considered in this paper and the particular problem that it seeks to resolve in part three. Part four will critically consider the UK model of ring-fencing, with part five exploring the US approach by way of contrast. The final part of the paper will critically reflect upon how ring-fencing fits into the reformed financial regulatory framework and analyse the utility of the UK's approach as a model for other jurisdictions.

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[8] Financial Stability Board '*Structural Banking Reforms: Cross-border consistencies and global financial stability implications. Report to G20 Leaders for the November 2014 Summit*' 27 October (2014). The importance of monitoring the implementation of structural reform as it is implemented was noted at p2.
[9] Steven L. Schwarcz 'Ring-Fencing' (2014) 87 Southern California Law Review 69.

It must be noted that, at the time of writing, the UK is in the process of withdrawing from the EU ("Brexit") and its future relationship with the EU is far from certain. The UK's formal recovery and resolution mechanism for failing banks and financial institutions is currently aligned to the resolution mechanisms that exist in the rest of the EU,[10] as are its deposit guarantee arrangements which are overseen by the Financial Services Compensation Scheme ("FSCS").[11] It is not clear how far this alignment will continue into the future and this will be taken into consideration, where relevant, in the paper. The discussion below begins by providing some context for the arguments put forward.

Part one: Discussion

The extent to which the measures that have been put in place over the last decade will truly protect the financial system from shocks cannot be known until a new international, financial crisis emerges, but in November 2014, Mark Carney, Governor of the Bank of England and Chair of the Financial Stability Board ("FSB") went as far as to state that "Globally systemic banks that fail will in future be resolved without recourse to the taxpayer and without jeopardising financial stability".[12] In his view, the banking system was safer, simpler and fairer, than at the time of the international financial crisis which began in 2007. Safer, because previously undercapitalised banks were now

[10] In the UK through the Banking Act 2009 which implements the BRRD and SRM (n 1).
[11] DGSD 2009/14/EC (n 1) harmonised the amount of depositor protection across Member States at €100,000 (£85,000). This figure has now been confirmed in the Recast DGSD 2014/49/EU which also standardises repayment deadlines to 7 days and excludes protected deposits from bail in under the BRRD (n.1). Post-Brexit, the UK will no longer be bound by the Recast DGSD and will be able to decide on what level of cover to provide.
[12] Mark Carney, "The future of financial reform", 17 November 2014. Available at www.bankofengland.co.uk/publications (accessed 17 June 2015).

largely recapitalised; simpler, because standards of disclosure had been improved so that balance sheets provided a better reflection of contingent claims that had too frequently previously been hidden in complex finance chains; and fairer, with the introduction of "total loss absorbing capacity" (also known as "bail in")[13] for globally systemic banks to ensure that the taxpayer would not be called upon for bail outs.

Governor Carney's optimism was put to the test shortly after this statement was made; within two years of his remarks, a banking crisis in Italy led to government intervention using public funds in December 2016. The events in Italy demonstrated that the idea that the days of using taxpayer funds for the bailout of a financially distressed bank are not actually over, with a capital injection of at least €5 million being given by the Italian government to Italy's third-largest and oldest bank, Bank Monte dei Paschi di Siena, to prevent it from failing. Nevertheless, it is entirely reasonable to agree that, in general, banking systems (as a distinct element of the financial system as a whole) are in a better state than in 2007-8[14] and this has been demonstrated by the results of stress testing.[15]

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[13] Whereby banks must first have recourse to certain types of subordinated debt and shareholder funds before approaching governments for public money.

[14] As Sir John Vickers pointed out in his response to the House of Lords Economic Affairs Committee on 30 June 2015, Mr Carney referred to "*Globally*" (our italics) systemically important institutions; the possibility remains that national systemically important financial institutions could still cause problems. (See video recording of session available at: Parliamentlivetv http://parliamentlive.tv/event/index/2019e0ca-4235-4853-8c17-af30b00f3ee3?in=15:36:33 at approximately 16.28. Accessed 3 January 2018).

[15] The 2017 Bank of England stress testing results illustrated that, based on a scenario worse than that of the financial crisis, the banks tested could absorb £50 billion losses in the first two years of the stress and that no bank needed to strengthen its capital base. The report is available at: https://www.bankofengland.co.uk/stress-testing/2017/stress-testing-the-uk-banking-system-2017-results (accessed 3 January 2018). The *2016 EU-Wide Stress Test Results* published by the European Banking Authority on 29 July 2016 stated that the results demonstrated "resilience in the EU banking sector as a whole thanks to additional capital raising" but also that the "results for individual banks vary significantly" at p7. The results are available at:
http://www.eba.europa.eu/documents/10180/1532819/2016-EU-wide-stress-test-Results.pdf
(accessed 3 January 2018).

If all this has been achieved prior to the introduction of ring-fencing within the UK and in the absence of ring-fencing across the EU, it begs the question as to what possible *additional* benefits to financial stability ring-fencing brings to the table. This question is important, as there are a number of significant disadvantages associated with ring-fencing, including the high cost of its introduction, the issues it raises as to regulatory arbitrage and the risks it poses in preventing the free flow of capital across jurisdictions (both within and without a situation of financial crisis).[16]

It is the authors' contention that the Italian crisis has demonstrated that ring-fencing could have a role in supplementing the existing, (and as will be discussed, often inadequate) depositor protection arrangements that exist across the EU. Depositor protection is one of the components of the financial sector safety net, along with prudential regulation, lender of last resort facilities and a clearly defined mechanism for bank recovery and resolution. Depositor protection is thus key to maintaining financial stability and preventing contagion.

The rationale for the authors' thesis is as follows. Despite all EU Member States having to comply with the Recast DGSD[17] and provide minimum protection of 100,000 euros to each depositor, it appears from events in Cyprus,[18] Greece[19] and more recently in Italy, that many depositors simply do not trust in their governments to actually

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[16] Issues identified in the FSB Report '*Structural Banking Reforms'* (n 8) 1, 2.
[17] Recast DGSD 2014/49/EU (n 1).
[18] See, for example, Campbell, A. and Moffatt, P. *Protecting Bank Depositors After Cyprus* (2013) 1 NIBLeJ 4.
[19] See for example, http://www.bbc.co.uk/news/business-33303540 (accessed 4 January 2018).

be able to provide the protection being "guaranteed". This is hardly surprising as many European deposit guarantee schemes are not currently sufficiently funded to deal with a significant banking crisis and this will inevitably have an effect on public confidence.[20] This apparent lack of trust has most recently been seen in Italy where, according to the Financial Times, depositors at Banc Monte dei Paschi, on becoming aware of its financial problems, steadily withdrew funds throughout 2016 with withdrawals increasing during December 2016 as the crisis escalated.[21]

The fact that withdrawals by depositors in Italy continued in spite of the existence of the government deposit guarantee indicates that depositors do not believe themselves to be adequately protected from bank failure. This suggests that an additional layer of protection for deposits is necessary to provide depositors with confidence in the financial system. The necessary protection could be found through the introduction of some form of ring-fencing.

Whether ring-fencing should be adopted as a policy initiative to address this trust deficit, either within Italy or across the EU is, however, a matter of debate. It is clear from the latest European Banking Authority ("EBA") data that the level of *ex ante* funding of depositor protection schemes within the EU is insufficient for the level of protection that depositors would need should a financial crisis

[20] The latest data published by the European Banking Authority is for December 2016. See the *Deposit Guarantee Schemes Data* available at: https://www.eba.europa.eu/regulation-and-policy/recovery-and-resolution/deposit-guarantee-schemes-data (accessed 4 January 2018). For example, Italy's target for *ex ante* funding is 0.8% of covered deposits by 2024 to be held across both its schemes. In December 2016, its banks held covered deposits of approximately €668bn which required funding of €5.3 billion, whereas the actual funding at that date was €621 million: a shortfall of approximately €4.7 billion.

[21] Financial Times, 24 December 2016.

arise.[22] This leads to a risk that government (that is, taxpayers) money would have to bridge any gap in shoring up depositors. Nevertheless, it is the authors' view that it is not necessary for the EU to introduce the UK model of ring-fencing for the reasons that will be discussed below. Before this discussion can take place, the conceptual basis for and definition of ring-fencing must first be considered.

Part Two: Defining ring-fencing

Schwarcz observes that the term "ring-fencing" is used in a number of different contexts and that it is a term that is often both poorly and inconsistently defined.[23] His analysis (correctly, in the authors' opinion) recognises the necessity of defining this term carefully, in view of the importance of its application as a regulatory tool and its consequent real-world economic impact. He therefore defines the term from a functional perspective,[24] concluding that ring-fencing is a financial regulatory concept concerned with "legally deconstructing a firm in order to more optimally reallocate and reduce risk".[25]

Schwarcz's analysis provides a useful conceptual framework for understanding the UK model of ring-fencing as it is based on an understanding of four distinct situations in which ring-fencing is used in real-world cases. The first situation is where it is necessary to make an entity bankruptcy remote and so improve its

[22] EBA *Deposit Guarantee Schemes Data* (n 17).
[23] Schwarcz (n 8) 72.
[24] Schwarcz (n 8) 73.
[25] Steven L. Schwarcz 'Ring-Fencing' (2014) 87 Southern California Law Review 69, 72. The term is apparently little discussed academically. Charles Kerrigan did not, in fact, define the term in his article 'News from dictionary corner: a definition of the word ring-fence' (2013) 3 JIBFL 168 but instead set out a series of questions that may be asked to determine whether a ring-fence has been established.

creditworthiness (examples being securitisation models and the structure of utility companies). The second is to help a firm to operate on a standalone basis, so that the failure of entities close to it does not trigger its own collapse. The third situation is where ring-fencing is necessary to preserve an entity's business and assets, for example, during the process of an acquisition, by ensuring that all interaction between the acquirer and the target takes place on an arm's length basis. The final use of ring-fencing is as a means of limiting a firm's risky activities and investments. This latter use is clearly relevant in the banking context, as are the second and third uses of ring-fencing to the extent that they relate to the protection of essential bank services and provide for the smooth resolution of a failing bank. Schwarcz sees ring-fencing as a subset of economic regulation. This is pertinent to the discussion that follows because, as he identifies, the function of economic regulation is to prevent market failure within the financial system and this includes the reduction of systemic risk.[26]

Although the two are linked, ring-fencing by means of the structural separation of bank functions must be distinguished from the form of bank ring-fencing discussed by D'Hulster and Ötker-Robe and described by them as "geographical" ring-fencing.[27] This latter form of ring-fencing is used by banking groups operating across borders to ensure that certain parts of the bank will remain self-sufficient even if other parts of the group fail. Self-sufficiency may be achieved in a number of ways, but it generally involves the imposition of higher than usual capital or liquidity requirements for certain parts of the

[26] Schwarcz (n 8) 84.
[27] Katia D'Hulster and Inci Ötker-Robe 'Ring-fencing cross-border banks: An effective supervisory response?'[2015] 16 (3) Journal of Banking Regulation 169.

group or the restriction of the payment of dividends or on liquidity flows. As the authors note, this form of ring-fencing is generally viewed negatively as it is, essentially, a territorial approach to a cross-border problem and one which will be discussed further in this paper. Before this discussion can take place, it is necessary first to explain the sense in which the term ring-fencing is being used for the purposes of this paper and why it might be considered a useful regulatory tool in this context.

Part Three: The form of ring-fencing and the problems that it seeks to resolve

In this paper, the form of ring-fencing that is being considered is the structural separation of retail banking, that is banking which involves consumers and small businesses, from wholesale and investment banking within an otherwise "universal" bank with the aim of reducing the risks to which the retail banking arm is exposed. As explained by James Proudman from the PRA:

> "Ring-fencing addresses the problem that arises from universal banks that allow investment and international banking activities to be placed on the same balance sheet as the critical functions of lending, deposit-taking and payment services for retail and small corporate customers. This increases the risks to the provision of those critical functions, and potentially puts tax payers on the hook to save the whole bank, if things go wrong in the investment bank or the global economy."[28]

[28] James Proudman, Executive Director UK Deposit Takers Supervision, PRA, Bank of England in his speech 'Putting up a fence" delivered at the British Bankers Association, 16 June 2017, 3.

In order to understand why ring-fencing is being implemented in the UK, the circumstances that have led to it must also be understood. Before the financial crisis of 2007, the model of the universal bank was, arguably, the paradigm as it was considered to be the most efficient way to provide banking services.[29] Universal banking was considered advantageous because it not only enabled banks to offer all their business lines under one roof, but it also enabled them to maximise the efficient use of their capital. Clients benefited from having ease of access to both retail and investment banking services through the same entity, whilst banks benefited because the capital (and now liquidity) requirements imposed under the Basel regime[30] were based upon the risks posed by the consolidated banking group, as opposed to those posed by the different branches of work that each part of the bank undertook. The model also enabled the diversification of risk across a number of business lines so reducing costs of funding and the large scale of the operation meant that the business could benefit from the economies this provided through the centralisation of support services, such as human resources and information technology ("IT").

Whether these efficiency advantages were actually borne out in reality is a moot point: a literature review on determinants of different business models conducted by Gambacorta and van Rixtel suggests that the evidence for economies of scope and scale in large banks is mixed, and may even have assisted in benefiting banks by

[29]Leonardo Gambacorta and Adrian van Rixtel 'Structural bank regulation initiatives: approaches and implications' (2013) BIS Working Papers No.412, 1; Bank for International Settlements 83rd Annual Report Chapter V 'The road to a more resilient banking sector' (2013) 57 (both available at www.bis.org); and the Vickers Report (n 8) (all accessed 23 June 2015).
[30] Now enacted in the EU through CRD IV (the CRR and CRD) (n 1).

enabling them to achieve TBTF status.[31] Nonetheless, the management of retail banking functions alongside investment banking functions through a universal banking structure was largely uncontroversial until 2008.

It is also the case that, although the concept of the universal bank has been in existence for several decades, there has been a gradual change in the focus of the kinds of activities undertaken by these banks. Banks have always pursued their core, commercial functions of taking deposits and making loans but, over time, wholesale banking and certain investment banking activities have grown in importance. Securitisation became more widely used in the UK during the 1990s as a model for enabling banks to remove particular risks from their balance sheets and place them in special purpose vehicles.[32] During the same period, banks also become more involved in the securities markets and a few extremely powerful G-SIBs emerged.[33] Understanding the role of the G-SIBs in investment banking activities is critical to this discussion, since it was their connection to the shadow banking sector which caused them to become unstable during the financial crisis.[34] It is beyond the scope of this article to consider shadow banking in any detail other than to note that shadow banking institutions were not subject to the same degree of regulatory scrutiny as banks, nor were they subject to the

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[31] Gambacorta and van Rixtel (n 15) 8.
[32] Lord Turner 'Turner Review' (2009) 15. Securitisation was already widely used in the US. Northern Rock, Bradford & Bingley, Alliance and Leicester and HBOS all grew significantly at this time, relying on wholesale (interbank) funding and programmes of continuous securitisation to do so. See Turner Review 35, available at <http://www.fsa.gov.uk/pubs/other/turner_review.pdf> (accessed 5 January 2018).
[33] Liikanen Report (n 10) 13; Turner Review (n 32) 36.
[34] Shadow banking is defined by the FSB as "credit intermediation involving entities and activities (fully or partly) outside the regular banking system" in the Financial Stability Board Report to G20 Leaders *Overview of Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability* 14 November (2014) 17.

same prudential requirements, which enabled problems in that sector to seep into the mainstream banking sector.[35]

The UK's largest banks at the time of the financial crisis were Barclays, HSBC, HBOS, Lloyds and Royal Bank of Scotland ("RBS"). All were then considered systemically important, but only Barclays, and HSBC now appear on the FSB's current list of G-SIBs.[36] Barclays, and HSBC survived the financial crisis without UK government financial support, but the others did not. RBS and HBOS failed for different reasons, but both failed because they had placed over-reliance on their non-core banking activities. HBOS failed because it relied on wholesale funding, much of which was short term, and so suffered from a lack of liquidity. RBS failed because it had acquired the Dutch bank ABN Amro at a very high price in 2007. When it suffered losses from its proprietary trading, structured credit and derivatives activities in 2008, it held inadequate amounts of capital to absorb the financial shocks it was then exposed to.[37]

These examples illustrate the particular problem for a universal bank, namely, that at any given moment, the entire bank is exposed to the risks borne by its investment banking work. (The corollary is, of course, also true in that the investment banking arm is also exposed to the risks borne by the deposit-taking side, but the risks posed by the deposit-taking work of these banks are not documented as having

[35] Financial Stability Board Interim Report of the FSB Workstream on Securities Lending and Repos *Securities Lending and Repos: Market Overview and Financial Stability Issues* 27 April (2012) 9. Within the UK, many of these institutions were subject to oversight from the Financial Services Authority, but this would not have been for the purpose of monitoring their bank-like functions for their impact on the stability of the entire financial system.

[36] Financial Stability Board '2017 list of global systemically important banks (G-SIBs)' 16 November (2018) available at financialstabilityboard.org. (Accessed 21 November 2018) HBOS was subsequently acquired by Lloyds TSB in 2009. Lloyds and TSB have since separated and Lloyds is no longer considered systemically important. RBS appeared on the 2017 list but was removed in 2018.

[37] Vickers Report (n 8) 32-33.

been a cause of the financial crisis.) In other words, the deposits of ordinary consumers and small businesses are put at risk if the bank's investment banking obligations cannot be met, leading to the possibility of a run on the bank. It also provides for the possibility of problems in the payments systems and this is a significant and potentially systemic problem as there is a risk of contagion because of the inter-connected nature of banks.

An appreciation of this context is key to understanding the need (or not) for ring-fencing: it only takes a short leap of imagination to conclude that, if deposit-taking banks had not been exposed to these kinds of investment banking activities, the financial crisis might have been avoided, or at least, might not have been so severe. One argument from history in support of this view is that advanced by US Senator Elizabeth Warren, who contends that the separation of high risk investment banking activities from commercial banking activities under the US Glass-Steagall Act of 1933, was responsible for a prolonged period of financial stability within the US until its repeal in 1999.[38]

If only matters were so clear cut. The reality is that a bank's investment banking activities may usefully be used to fund and support its retail banking functions, such as the payment of interest to depositors. Banks have introduced innovative financial products to improve yield and securitisation models were adopted largely

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[38] Elizabeth Warren. See http://elizabethwarren.com/blog/glass-steagall and sec 2 of 'Findings and Purpose' of the 21st Century Glass Steagall Act of 2013 (her Senate Bill) reintroduced on 7 July 2015 and available at: http://www.warren.senate.gov/files/documents/21stCenturyGlassSteagall.pdf. See also http://www.doddfrankupdate.com/DFU/ArticlesDFU/Senators-reintroduce-bill-with-GlassSteagall-prote-64276.aspx and John Authers 'Markets make best case for Glass-Steagall' 14 July 2013 at http://www.ft.com/cms/s/0/14e08822-eb04-11e2-9fcc-00144feabdc0.html#axzz3gLjC8WaM (all accessed 4 January 2018).

because they were thought to reduce risk. So when undertaken carefully and correctly, many of the investment banking activities performed by banks in the period leading up to the financial crisis were perfectly sensible activities for them to undertake (and indeed, banks did not stop carrying out these activities after the crisis). It is also the case that some activities cannot be compartmentalised easily into "retail bank functions" or "investment bank functions" since some retail customers may benefit from investment bank activities specifically designed to protect them from risk, for example, through interest rate or currency hedging arrangements. Nor does this model necessarily address the position of banks which are solely retail or solely investment banks.

But if retail bank functions are to be ring-fenced from investment bank functions, how is this best achieved? This was considered by the Independent Commission on Banking in the Vickers Report, the recommendations of which form the basis for the UK model of ring-fencing.[39] The Vickers Report concluded that there were two main considerations in creating an effective ring-fence: first in determining the location of the fence, that is, what activities should be separated for protection within the ring-fence; and second, in determining the height of the fence, being the corporate structure through which "mandated" services could be isolated from "prohibited" investment banking activities.[40] These elements will now be considered in more detail.

[39] Independent Commission on Banking *Final Report, Recommendations* September 2011.
[40] Vickers Report (n 36) 36, 62.

Part Four: The UK Model of Ring-fencing[41]

The Vickers Report determined that the purpose of ring-fencing was to isolate essential retail banking activities and insulate them from shocks within the financial system so that these essential services could be maintained in a financial crisis. In addition, a ring-fence would curtail reliance on implicit government guarantees and enable failing banks to be more easily resolved without recourse to taxpayers' funds.[42] Whilst the Vickers Report acknowledged the work of the FSB, the Basel Committee on Banking Supervision ("BCBS") and the EU in addressing capital issues, it took the view that the Basel baseline capital requirements were too low, particularly for G-SIBs and ultimately recommended a higher level of loss-absorbing capacity.[43] It concluded that the combination of its proposed initiatives on ring-fencing and increased loss absorbing capacity would facilitate bank resolution and, as losses would not require taxpayer support, these initiatives would also enhance competition.[44] The focus in this part will be on the Vickers Report findings on ring-fencing, the principles it outlined and how these have been translated into FSBRA 2013 and developed into the policy that will ultimately be applied to banks from 1 January 2019.

The location of the fence

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[41] Although the focus of this paper is on ring-fencing, it is important to note that the ICB's overall brief was to consider both structural and non-structural reforms, with a view to promoting financial stability and competition in the UK banking sector.[41] Its proposals on ring-fencing were, therefore, one of a number of complementary policies.

[42] Vickers Report (n 36) 35.

[43] Vickers Report (n 36) 9, 13.

[44] Vickers Report (n 36) 14.

The Vickers Report designated the taking of retail deposits from and provision of overdrafts to both individuals and small and medium-sized businesses ("SMEs") as mandated services requiring protection and recognised the importance of maintaining payment services. It is submitted that the identification of these services is uncontroversial; it is increasingly recognised that certain banking services are a form of public utility and that public access to them is essential for daily life. [45] Any temporary interruption to continuity of these banking services would cause problems within the wider economy and, as consumers and SMEs generally have no alternative to using banks for the provision of these services, they would be badly affected by their withdrawal. [46] The Greek credit controls that were imposed in the summer of 2015 and which led to an extended bank holiday are illustrative of the real hardship that the suspension or limitation of these functions can cause to individuals and SMEs.[47]

The first principle of the Vickers Report was that "only ring-fenced banks should be granted permission by the UK regulator to provide mandated services".[48] The principle was intended to apply to any bank permitted by the regulator to carry on business in the UK as a distinct legal entity. This meant that the principle would apply to deposit-taking UK banks which were part of a banking group, whether their headquarters were in the UK or whether they were the UK bank subsidiary of a group with headquarters in another jurisdiction.[49]

[45] See the discussion in the House of Commons Treasury Committee Fifth Report of Session 'The Run on the Rock' (1) (2008) 75.
[46] Vickers Report (n 36) 38.
[47] BBC (n 18).
[48] This definition included building societies. Vickers Report (n 8) 38.
[49] Vickers Report (n 8) 39.

Principle 2 identified the activities which a ring-fenced bank should be prohibited from undertaking. These were, broadly, activities that would impede the possibility of the bank's resolution or increase its exposure to the global financial markets, plus any activities that were not directly relevant to the provision of payment or credit intermediation services in the non-financial sector. Activities that might threaten the objectives of the ring-fence would also be prohibited.[50] So whilst the Vickers Report concluded that wholesale and investment banking services were not integral to the credit intermediation process, it also recognised the importance of the distinction between lending to the financial sector and the non-financial sector. Its approach was, therefore, nuanced: it was not a question of a "blanket ban" on certain activities, but a consideration of the extent to which they breached the principles it had identified.

FSBRA 2013 has adopted much from the Vickers Report in relation to the location of the fence. It defines a "ring-fenced body" as a UK institution, incorporated in the UK and which has been authorised[51] to carry on a core activity. Although FSBRA 2013 refers to both "core activities" and "core services", the only defined core activity is that of deposit-taking. Core services are services that are linked to core activities and, consistently with the Vickers Report, comprise deposit, overdraft and payment services.[52] The ring-fencing rules are intended only to apply to institutions that take deposits as a core activity and so entities with a core activity below £25 billion will be exempt.[53]

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[50] Ibid (n 8) 52-53.
[51] Under Part 4A of FSMA.
[52] FSBRA 2013 section 4(1) inserting new FSMA sections 142B and 142C.
[53] FSBRA 2013 section 4(1) inserting new FSMA section 142A and FSMA 2000 (Ring-fenced Bodies and Core Activities) Order 2014, SI 2014/1960, Article 12. Article 2 recognises that some high net worth

The critical part of the location of the ring-fence concerns the activities that a ring-fenced bank cannot undertake; in other words the excluded activities.[54] Dealing in investments as principal is the only activity stated to be excluded under FSBRA 2013, although the Treasury can make orders excepting an entity from this exclusion as well as adding other activities to the list of excluded activities or prohibiting ring-fenced entities from involvement in specific activities.[55] Any prohibition would be based on the activity adversely affecting the provision of core services.

Despite the fact that many of the recommendations of the Vickers Report have been reflected in the new legislation it is less than clear how effective they will be. For example, the Treasury has the power to make orders to enable institutions to avoid the ring-fencing requirements in certain circumstances. It seems unlikely that the Treasury would rush to make such orders unless it was appropriate to do so as this would be politically inexpedient (particularly since the implementation of ring-fencing was included in the 2015 Conservative party manifesto).[56] The political position may, as a result of the new government team after the Brexit vote, however, no longer be the same. Although noting his bank's commitment to ring-fencing, the Chairman of HSBC has indicated in the past that the bank is unhappy about the costs associated with its implementation

individuals who are sophisticated investors may wish to make deposits in excess of the £85,000 that is protected under the UK deposit guarantee scheme and such deposits are excluded from the definition of core deposit. Building societies are specifically excluded from the scope of the rules although FSBRA 2013 section 7 anticipates that amendments may be made to the Building Societies Act 1986 if necessary; they will usually be exempt because if their size.

[54] FSBRA 2013 section 4(1) inserting new FSMA section 142G.

[55] For example, entering into specified kinds of transactions, setting up a branch in a specified territory or holding specified shares. FSBRA 2013 section 4(1) inserting new FSMA sections 142D and 142E.

[56] Available at https://www.conservatives.com/manifesto, p9 (accessed 29 July 2015).

and has suggested that ring-fencing may not carry the benefits envisaged by its proponents. Ring-fencing is also one of a number of reasons previously cited by the board of HSBC for a possible relocation of its headquarters from the UK.[57] Although this may simply have been low level sabre-rattling by HSBC, if the UK government were to consider that HSBC's move to another jurisdiction would be a loss to the standing of the UK in the financial markets, they may be inclined to soften their stance on the strength of the ring-fence.[58] With much of the work on ring-fencing now complete, this may now be less of an issue. To the extent that it remains a concern, it must be noted that there has been no indication of the current, post-Brexit government's views on ring-fencing although this may only be because of its pre-occupation with Brexit itself; it seems likely that any loss of HSBC's UK business would be perceived as a detriment to the standing of the UK in a post-Brexit world.[59]

The fact that the Treasury may make orders carries the prospect that they will attract little scrutiny. Whether this is a matter of real concern will depend upon the rigour of the oversight provided by the Prudential Regulation Authority ("PRA") and the Financial Conduct Authority ("FCA") which will be responsible for monitoring the activities of ring-fenced bodies.[60] Bearing in mind that the regulators'

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[57]Jonathan Symonds, Chairman of HSBC Bank plc and George Culmer, Executive Director and Chief Financial Officer of Lloyds Banking Group both attended the House of Lords Economic Affairs Committee on 30 June 2015. For Mr Symonds remarks, see Parliamentlivetv (n 4) 16.36 minutes.

[58] The focus of HSBC's business means that implementing ring-fencing will be more costly than it would be for other banks: 97% of Lloyds business is in retail banking compared to 30-40% of HSBCs. Parliamentlivetv (n 4) 16.46 minutes.

[59] According to the Independent newspaper on 30 October 2017, HSBC may move up to 1,000 staff from London to Paris following Brexit. <http://www.independent.co.uk/news/business/news/brexit-latest-news-hsbc-bank-jobs-move-paris-city-london-leave-eu-a8027131.html> accessed 5 January 2018.

[60] Although it is not anticipated that there will be any ring-fenced bodies that will not be subject to PRA authorisation. See Bank of England Prudential Regulation Authority Consultation Paper I CP19/14 'The

remit is to ensure that the business of a ring-fenced-body is conducted so that it avoids any adverse effect on the continuity of the provision of core services in the UK,[61] individual banks should only benefit from a relaxation of the rules where the regulators are satisfied that there will be no such adverse effect. This protection assumes, however, that the regulator and the Treasury will form the same opinion, since it is the opinion of the Treasury, rather than the regulator, that is applied in this event.[62] Although this provision is aimed at smaller institutions which have limited impact within the global market place, it is possible that, as memories of the financial crisis start to fade and no obvious disasters ensue, there could be a gradual "creep" in the number of banks subject to such relaxations and a consequent re-exposure of retail banks to investment banking activities.

Whilst the exclusion from dealing in investments as principal is a blanket ban, the legislation reflects the need for a ring-fenced body to be able to operate commercially.[63] Not all derivatives contracts are prohibited (for example, those to enable customers to hedge their interest rate or currency arrangements), although they are subject to a number of limitations.[64] How easy it will be in practice to determine whether a ring-fenced body is undertaking a particular transaction as principal or in order to, for example, hedge a customer risk, may

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implementation of ring-fencing: consultation on legal structure, governance and the continuity of services and facilities' October (2014) 9.

[61] FSBRA 2013 sections 1 and 2 respectively amend the FSMA 2B PRA objective to include ring fenced bodies and create a FSMA FCA continuity objective in respect of ring-fenced bodies.

[62] FSMA 142D (3).

[63] SI 2014/2080 The Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014. Part 2 sets out the excluded activities and exceptions. Commodities trading is permitted, for example, where the commodities are required for the ring-fenced body's own use or their use by one of its subsidiaries (Article 5(2)).

[64] SI 2014/2080 Articles 9-12 (n 59). For example, not exceeding a position risk greater than 0.5% of the ring-fenced body's own funds. There are a number of other parameters.

prove challenging. The latest PRA guidance indicates that the reporting requirements for banks require information to be provided only insofar as is necessary for the PRA to understand "where firms are potentially not compliant, or are taking risks that might adversely affect the continuity of provision of core services" which is suggestive of a pragmatic approach.[65]

The height of the fence

The last two principles identified in the Vickers Report relate to the height of the fence. Principle 4 addressed the extent of the legal and operational links between a ring-fenced bank and the rest of its corporate group and principle 5 the scope of its economic links with other group members. Mindful of the benefits of universal banking, the Vickers Report recommended that services necessary for the ring-fenced part of the bank to operate should be separable from the non-ring-fenced part, so that ring-fenced activities could continue if the non-ring-fenced part failed. Additionally, access to the payments system should only be through a ring-fenced bank to avoid issues of operational and liquidity risk[66] and relationships with non-EEA institutions should be limited. All relationships between the non-ring-fenced and the ring-fenced parts of the bank should be conducted at arm's length and the ring-fenced element should be able to meet regulatory requirements as to capital and liquidity on a standalone basis.[67] In this way, the Vickers Report distinguished its concept of ring-fencing from the Glass-Steagall model; its version was a

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[65] PRA Policy Statement PS3/17 'The implementation of ring-fencing: reporting and residual matters-responses to CP25/16 and Chapter 5 of CP36/16' February 2017.
[66] Vickers Report (n 36) 67.
[67] Ibid (n 36) 71-72; SI 2014/2080 Article 13.

"halfway house" through which a degree of separation could be enforced in order to provide the benefits of stability.[68]

These recommendations have been adopted by FSBRA 2013[69] and taken forward in the final rules issued by the PRA.[70] The PRA has opted for a "sibling structure" within a banking group which enables a non-ring-fenced UK holding company to cluster its subsidiaries into ring-fenced and non-ring-fenced groups.[71] As subsidiaries of ring-fenced bodies must themselves conduct only ring-fenced activities, this structure is intended not only to simplify the process of resolving the ring-fenced body in the event of the group's insolvency, but also to prevent investment banking risks from flowing into it.[72]

A localised ring-fence has also been established, in that a ring-fenced body (which could include the UK subsidiary of a foreign bank if it meets the threshold on deposits) cannot have a branch or a participating interest[73] in an undertaking carrying out regulated activities outside an EEA member state.[74] As the ring-fence does not apply to foreign banks with branches in the UK or to UK banks with

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[68] Ibid (n 36) 66.
[69] FSBRA 2013 section 4 inserting new FSMA sections 142H, I and J.
[70] PRA Policy Statement PS20/16 'The implementation of ring-fencing: prudential requirements, intragroup arrangements and use of financial market infrastructures' July 2016. There have been several iterations of the rules. Much of the detail was set out in the original PRA Consultation Paper CP19/14 in October 2014. These were followed by Policy Statement PS10/15 'The implementation of ring-fencing: legal structure, governance and the continuity of services and facilities' which indicated that no major changes to the proposals were necessitated (see PS10/15 5). Further consultations subsequently took place with the issue of CP33/15 'The implementation of ring-fencing: the PRA's approach to ring-fencing transfer schemes' September (2015); CP37/15 'The implementation of ring-fencing, prudential requirements, intragroup arrangements and use of financial markets infrastructures' October (2015); and CP38/15 'Ensuring operational continuity in resolution' October (2015). All are available at www.bankofengland.co.uk (accessed 5 January 2018).
[71] See PRA Supervisory Statement SS8/16 'Ring-fenced Bodies (RFBs)' December 2017 Chapter 2. Available at www.bankofengland.co.uk (accessed 5 January 2018).
[72] Ibid.
[73] A participating interest is defined in section 421A FSMA "an interest held by an undertaking in the shares of another undertaking which it holds on a long-term basis for the purpose of securing a contribution to its activities by the exercise of control or influence arising from or related to that interest". A 20% shareholding is assumed to be a participating interest.
[74] SI 2014/2080 (n 47) Article 20. Although the

non-ring-fenced subsidiaries in other jurisdictions, the ring-fence is not thought to affect the competitive conditions in the wider financial markets. Limiting any interest in an undertaking based outside the EEA to one that is less than a participating interest will, presumably, encourage any non-EEA entity to create a subsidiary in the UK if it wanted to undertake ring-fenced work (as was envisaged in the Vickers Report). Ironically, the rules would permit a UK bank to re-locate to an EEA jurisdiction and then set up a branch in the UK that would not be governed by the ring-fencing requirements, but this seems an unlikely outcome. First, it would damage the reputation of any bank that decided to do this (at a time when the reputation of banks is not high with the public). Second, it would be costly for a bank to transfer its retail customers as individual depositor consents would be required.[75]

The requirement for economic separation relies heavily on the notion that the board of the ring-fenced body will act independently of its UK holding company.[76] To this end, the PRA has set out rules as to the composition of the board as well as a determination of when a director is to be regarded as independent.[77] As a matter of general company law, the directors of a company are required to act in the best interests of their company, so it is worth exploring why this additional protection is thought necessary.[78] In a complex corporate banking group the board of the ultimate holding company will set the strategy and direction for the group as a whole, which will have

[75] Vickers Report (n 36) 65.
[76] James Proudman 'Putting up a fence' (n 27) 4.
[77] The chair and half the board must be non-executives. PRA 2016/26 'PRA Rulebook: CRR Firms and Non-Authorised Persons: Ring-Fenced Bodies Instrument 2016', Chapter 4 *Board Composition and Membership.* Available at: http://www.prarulebook.co.uk/rulebook/Media/Get/a3acd4bd-9807-47c3-9f33-3236c3022a18/PRA2016-26/pdf accessed 5 January 2018.
[78] Section 172 Companies Act 2006.

implications for the workings of its subsidiaries. Where these subsidiaries are ring-fenced bodies, potential conflicts may arise if the corporate direction requires those ring-fenced bodies to undertake an activity that may weaken or breach the ring-fence. This tension raises two issues for corporate groups: first, will the ring-fenced body be able to resist the pressure from its parent; and second, a question raised by Lord Lamont, as to why would the parent want to own a company that it could not control?[79]

The second issue is more easily resolved than the first: if the ultimate parent of a ring-fenced body does not like the loss of control that results from the implementation of ring-fencing, then it can simply sell the retail side of the bank.[80] The first issue is more difficult, as it relates to the culture of the organisation and the ability of the directors of the ring-fenced body to resist pressure that may be exerted upon them by senior executives to lift, or somehow modify, the ring-fence. Whilst a director may be able to resist overt pressure, it may be harder if the pressure is subliminal; as Keay observes, directors (like anyone else) are not always aware that they are affected by bias.[81]

The directors of a ring-fenced body could take comfort from section 172(3) Companies Act 2006 should they face pressure from their parent to relax the ring-fence requirements. It is accepted that where

[79] Discussed in the House of Lords Economic Affairs Committee on 30 June 2015. Lord Lamont asked "why own something you can't control?" Parliamentlivetv (n 4) 16.00 mins.
[80] Sir John Vickers considered separation could be the best course in such a case but did not think that this was a "killer" objection to ring-fencing. Parliamentlivetv (n 4) 16.00 mins.

[81] Andrew Keay 'Authorising Directors' Conflicts of Interest' (2012) 12 1 Journal of Corporate Law Studies 129, 144. The focus of Professor Keay's paper is on section 175 Companies Act 2006 and so is not on all fours with the present discussion, but the points on bias and independence are instructive.

a company is in financial difficulties, the duty of its directors shifts from a duty owed to the company to a duty owed to its creditors which, in the context of a ring-fenced bank, would include its depositors. Since the purpose of ring-fencing is to protect depositors from insolvency, it makes sense for the directors to have regard to their interests. The difficulty for the directors in relying on this provision is likely to be one of timing, since any request to avoid the ring-fencing requirements is likely to be made precisely because the company is not in financial difficulties and the insolvency risk to it is perceived to be low, whereas the shift in duty to creditors is generally invoked at a point at which a company is *in extremis.*

Beyond the board, responsibility for achieving the ring-fencing objectives will extend to Senior Managers for their specific area of business.[82] Senior Managers are to be vetted for their roles as part of the drive to regulate better the conduct of workers in the financial services industry. In addition, the board would be required to work closely with the PRA in its role of monitoring and enforcing the ring-fencing regime.[83] In the event that the PRA considers that a ring-fenced body within a banking group is being prevented from acting independently or is being adversely affected by the acts or omissions of other group member, then the PRA can restructure the group. This is the so-called "electrification" of the fence. The PRA can also exercise its restructuring powers where another member of the group has become insolvent and either cannot provide the ring-fenced body

[82] PRA Rulebook CRR Firms, Allocation of Responsibilities Rules 3.4 and 4.2(4).
[83] The provisions relating to senior management functions are set out in Part 4 of FSBRA 2013 and amend sections 59-66 FSMA.

with necessary services or the effect of the insolvency means that the ring fenced-body cannot continue its core activities.[84]

The PRA recognises that a degree of pragmatism will be necessary when implementing the rules, as different organisations will have different requirements and so has said that it will take a "proportionate approach".[85] How well banks will deal with intra-group challenges remains to be seen, but it must be remembered that they are sophisticated organisations and used to dealing with internal conflicts. They are also in the process of a cultural shift away from perverse incentives towards providing better service to customers.[86] This would suggest that, on balance, these mechanisms will enable directors to maintain the necessary independence for ensuring that the ring-fencing objectives are met. There is a practical concern in relation to the constitution of the boards, however. The pool of people with the skill set necessary to take on the role of independent director is very small, so the appointment of directors may prove difficult. As Katz points out, not only will it be hard to find people to apply, but people may be put off from applying if they are restricted from holding other directorships elsewhere.[87]

The structural separation that will be achieved by limiting the location of the work of ring-fenced bodies to the EEA has already been mentioned and it is here that the interface between the role of bank capitalisation and the concept of "geographical" ring-fencing become

[84] FSBRA 2013 section 4(1) inserting new FSMA section 142K.
[85] See PRA SS8/16 para 2.5 (n) and PRA PS3/17 para 4.3 (n). By way of example, a particular concern Lloyds Banking Group raised with the PRA was to ask whether it could avoid having a separate board for its investment banking work in view its small size. Parliamentlivetv (n 4).
[86] According to the Chief Operating Officer of Lloyds Banking Group. Parliamentlivetv (n 4) 17.12 mins.
[87] Etay Katz 'UK Bank ring-fencing: how will you build yours?' (2015) 1 Journal of International Banking and Finance Law 30.

important. A bank's location will be a factor in the outcome of its resolution, largely because banks have traditionally been stress tested on a consolidated basis. Cerutti and Schmieder have observed a general assumption drawn from stress tests that money available in one jurisdiction will be available to members of the same group based in other jurisdictions.[88] This is not always borne out in practice, however, as local regulators tend to focus on national financial stability in periods of financial crisis[89] when a host regulator may prevent funds from leaving branches of foreign banks based in its jurisdiction. So a bank that anticipated redistributing funds from one jurisdiction to another in order to stave off a bank failure elsewhere may be prevented from doing so to its detriment. The same situation may also arise in reverse in a case where a subsidiary in a host country may not be supported by a parent in the home jurisdiction. Cerutti and Schmieder conclude that this is less like to be a problem for banks where a similar approach to crises is adopted across jurisdictions (they cite the EU as an example) and that simply working on the basis of a consolidated balance sheet is not enough to ensure that a bank is protected in a financial crisis; unconsolidated data will give a truer representation of the bank's position.[90]

The PRA policy for determining the prudential requirements for ring-fenced bodies is based on the sibling structure it has advocated. This structure enables capital and liquidity requirements to be "sub-consolidated", so that the prudential requirements for ring-fenced

[88] Eugenio Cerutti and Christian Schmieder 'Ring fencing and consolidated banks' stress tests' (2014) 11 Journal of Financial Stability 1, 2.
[89] See, for example, D'Hulster and Ötker-Robe (n 14). Most obviously for reasons of political expediency.

[90] Eugenio Cerutti and Christian Schmieder 'Ring fencing and consolidated banks' stress tests' (2014) 11 Journal of Financial Stability 1, 2. Although it must be noted that the EU was not immune to this problem during the financial crisis. See, for example, D'Hulster and Ötker-Robe (n 14).

bodies can be consolidated within the ring-fenced arm of the business whilst remaining distinct from the non-ring-fenced part.[91] Combined with a more unified approach to bank restructuring across the EU under the BRRD (which will shortly be discussed), it is likely that the UK approach will help to overcome some of the disadvantages caused by geographical ring-fencing.

As noted above, it is not surprising that the ring-fencing requirements have not been welcomed by all those banks in the UK which will be affected by them. The reasons include the complexity of compliance and the additional costs associated with it. However, Antonio Horta-Osorio, Lloyds Bank Chief Executive believes that the "the principle behind it is right" and he did not feel it would be "too burdensome". Others however disagree with views ranging from it being 'actively harmful to the UK' to the extra costs being passed on to customers.[92] Particular concerns have recently been expressed in relation to Brexit as this is putting additional pressure on banks. Two particular difficulties for banks are first, that it is not clear what the passporting arrangements will be post-Brexit and second that it is not clear how the transition period (which would enable an orderly exit) will work.[93] This means that the five major UK banks are trying to deal with two sets of deadlines to accommodate the restructuring associated with

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[91] PRA SS8/16 Chapter 3. Sub-consolidation is permitted under the CRR (n16) Article 11(5) and ring-fenced bodies will be expected to comply with certain obligations under CRD IV (n 16) including capital adequacy, liquidity and Pillar 2 reporting.

[92] Financial Times, 'Global banks at odds over ring-fencing rules in UK' London 20 June 2015.

[93] The UK Government remains unclear on its approach to the transition and post-Brexit arrangements at the time of writing. In his speech at the World Economic Forum in Davos on 25 January 2018 the Chancellor Phillip Hammond stated that "We are taking two completely interconnected and aligned economies with high levels of trade between them and selectively moving them - hopefully very modestly - apart", whilst the BBC subsequently reported a Downing Street spokesman as saying that "While we want a deep and special economic partnership with the EU after we leave, these could not be described as very modest changes." BBC news report available at http://www.bbc.co.uk/news/uk-politics-42827270 (accessed 26 January 2018).

ring-fencing as well as any restructuring needed for their businesses post-Brexit in the absence of a deal.[94]

Having considered the UK model of ring-fencing that is shortly to be implemented, it now makes sense briefly to consider the approach to ring-fencing taken in the US to appreciate the lessons that may be learned both from its historical implementation in the form of the Glass-Steagall Act,[95] as well as its current iteration.

Part Five: The US Model of Ring-fencing

In 1933, approximately four years after the Wall Street Crash and the subsequent wave of bank failures, the US Congress passed the Glass-Steagall Act which effectively separated deposit taking banks from investment banks. This remained in place until 1999 when the Gramm-Leach-Bliley Act removed this separation.[96] When the financial crisis hit in 2008, many observers pointed to the removal of the ring-fence as the main cause of the financial crisis.[97] An analogy can perhaps be drawn between the behaviour of US banks during the booming economic period of the 1920s and their behaviour in the period between the repeal of Glass-Steagall and the start of the crisis in 2007/8.

Interestingly, although the US authorities took action in the wake of the recent crisis, the approach was not to reintroduce a Glass-Steagall form of ring-fencing. Instead, the US approach following the

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[94] Financial Times online 'Regulators get ready to authorise 'ring-fenced' UK banks' 19 August 2017 available at: <https://www.ft.com/content/5ca81a48-8372-11e7-a4ce-15b2513cb3ff> accessed 5 January 2018.

[95] It was actually part of the Banking Act 1933 rather than a separate Act.

[96] This was very controversial as many claimed that it was the powerful US banking lobby which managed to convince President Clinton that this development would be better for the US economy.

[97] See, for example, the comments of Senator Elizabeth Warren.

financial crisis was to prohibit deposit-taking banks whose deposits are insured by the Federal Deposit Insurance Corporation ("FDIC") from "engaging in proprietary trading and from acquiring or retaining ownership interests in, sponsoring, or having certain relationships with a hedge fund or private equity fund", subject to various exemptions and exceptions.[98] So rather than re-introduce a ring-fence, the new approach is to separate permitted activities from those that are prohibited.

This is now generally referred to as the Volcker Rule after Paul Volcker who had been the Chairman of the Federal Reserve and who was instrumental in its design. One of the criticisms of the Volcker Rule is that the definitions in the legislation lack precision. This has meant that it has been difficult to identify the distinction between permitted and prohibited activities and, therefore, the extent of its application. In order for the rule to be enforced, institutions are required to report to the regulator to enable compliance to be monitored. The prohibitions are aimed at preventing activities which are perceived to bear too high a risk. These include prohibiting proprietary trading which means that deposit-taking banks are not allowed to trade in certain forms of securities on their own behalf as principal and also that deposit-taking banks are not permitted to have any ownership interests in such vehicles as hedge funds and private equity funds. The approach is significantly different to that of the Glass-Steagall legislation and the UK ring-fencing model, in that the Volcker Rule does not require the complete separation of all investment banking

[98] From the explanation of the Volcker Rule by the Board of Governors of the Federal Reserve. Available at http://www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm. The prohibition appears in section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (US) which added a new section 13 to the Bank Holding Company Act of 1956 (US).

activities from commercial banking activities. It does mean, however, that deposit-taking banks cannot get involved in high-risk activities where they trade as principal. As with the UK regime, there are exemptions to enable customers to take part in specific, low risk hedging transactions and so both regimes achieve similar outcomes.

The Volcker Rule, although in force since 2012, has not yet been fully applied with a number of time extensions for compliance having been granted. Indeed in August 2016 a number of leading investment banks have asked the Federal Reserve to allow a further extension until 2022.[99] As President Trump has already suggested that Dodd-Frank will be repealed, it may prove to be the case that the Volcker Rule never actually becomes fully effective.

Part 6: Concluding Thoughts

The UK's ring-fencing policy will go some way both towards ensuring the continuity of banking services in an insolvent banking group and in achieving the objectives set out in the Vickers Report. Based on the recent Italian financial crisis, it seems clear that it would enhance the confidence of depositors in the UK's financial system. While it seems unlikely that UK depositors would not have trust in the FSCS to provide the level of protection which has been guaranteed, the existence of the ring-fence, if it proves to be effective, should make it far less likely that the provision of compensation to depositors would ever be necessary.

[99] www.cnbc.com 'EXCLUSIVE Wall St banks ask Fed for 5 more years to comply with Volcker Rule' by Olivia Oran 11/8/16. Accessed 7/1/17.

The strengths of the UK model are first, the separate capitalisation of ring-fenced bodies as this should help to protect core services from financial system shocks and second, the direct connection of the ring-fenced body to the payments systems to prevent contagion. It also seems likely that ring-fencing will facilitate the resolution process, since the pre-resolution separation of business lines at an operational and economic level should help speed up any future resolution process. Despite this, it remains open to question whether the Vickers Report objective that ring-fencing will reduce the amount of taxpayers' money that will be required if a G-SIB were to fail in the future will be met.

Ring-fencing has undoubtedly been very expensive to introduce with ongoing costs for the banks estimated to be somewhere between £1.7bn and £4.4bn per year.[100] Nor will the costs of ring-fencing be evenly spread across banks, as the ultimate bill for any bank will depend upon the extent of its international activities as well as its balance of core activities to non-core (investment type) activities. HSBC has previously questioned whether it is strictly necessary to implement ring-fencing at a time when banks are under pressure to improve their customer service and governance arrangements as well as implementing all the other post-crisis legislative initiatives, all of which carry their own costs. The external pressures on UK banks have worsened, post-Brexit[101] whilst at the same time, they must

[100]HM Treasury 'Banking reform: draft secondary legislation' July (2013) 78 available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/223566/PU1488_Banking_reform_consultation_-_online-1.pdf (accessed 2 November 2015). See also James Proudman 'Putting up a fence' (n 27) 4: ring-fencing is "expected to have cost the industry several billion pounds in total by 2019".

[101] As discussed in Part Four.

introduce "arguably, the largest ever discrete change to the structure of the UK banking system."[102]

Despite this, the proportionate approach that has been taken by the PRA to the implementation of ring-fencing suggests an element of pragmatism and a business-like intention to making it work. The rules have been carefully considered through consultation and the implementation will be phased over 2018 in order to deal with any problems as they arise and suggesting a clarity in approach that is lacking in the application of the US Volcker Rule.

Although the UK banks have no choice about ring-fencing, it is nonetheless worth reflecting whether it is a model that should be adopted elsewhere, particularly within the EU, to the extent that the UK model could damage EU business as a result of unfavourable regulatory arbitrage. This analysis requires a consideration of the place of ring-fencing amongst the raft of other regulatory and prudential requirements that have been introduced in recent years which will now briefly be considered.

The gradual implementation of the FSB's Key Attributes for Effective Resolution Regimes[103] has led to the creation of crisis management groups and cross-border cooperation agreements ("COAGs") for G-SIBs and G-SIFIs, enabling discussions to take place on a regular and planned basis between home and host regulators as to how complex

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[102] James Proudman 'Putting up the fence' (n) 3.

[103] Financial Stability Board 'Key Attributes for Effective Resolution Regimes', October 2011 and the Financial Stability Board Report to G20 Leaders 'Overview of Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability', 14 November 2014. (Available at www.financialstabilityboard.org, accessed 25 June 2015).

bank resolutions will be managed.[104] The BRRD requires banks to produce RRPs setting out their plans for recovery and resolution (including mechanisms for the separation of viable parts of the business) in the event that their financial position deteriorates. This means that there is some duplication of effort for banks that also have to produce a ring-fencing model.[105] The point of the RRPs is to enable national regulators to work across borders, respecting each other Member State's arrangements so that EU wide banking groups can be resolved in an orderly fashion. The existence of such coherent arrangements coupled with the implementation of new prudential and regulatory mechanisms across the EU may be enough to address the problems of cross-border bank failure to which ring-fencing will add little. The position with the US is slightly different; after all, the memorandum of understanding on the resolution of a G-SIFI that exists between the UK and the US is not based on an underlying legal framework. The fact that Australia (a country similar to the UK in that it has a few, dominant banks) has actively decided not to ring-fence on the basis that it will work on its other regulatory measures is, however, persuasive.

Great improvements have been also made within the UK and EU strengthening depositor protection regime.[106] In 2007, there were differing levels of depositor protection available in different Member States and within some, including the UK, the depositor protection arrangements included an element of coinsurance, which exacerbated the Northern Rock crisis when customers realised that

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[104] FSB Key Attribute 8 (n7).

[105] BRRD (n 5) and FSB Key Attributes (n 7). Under the BRRD, small institutions have simplified obligations.

[106] For a useful overview of the changes see Jennifer Payne 'The Reform of Deposit Guarantee Schemes in Europe' ECFR (2015) 539-562.

they would not get full compensation for their deposits.[107] The DGSD was subsequently amended to harmonise the position within the EU by ensuring that all Member States guaranteed deposits up to €100,000[108] and further improvements have since been made with regard to the timing of payouts to customers.[109] In addition, the DGSD now requires Member States to contribute to an *ex ante* funded scheme of up to 0.8% of covered deposits, although Member States have until 2024 to achieve this.[110] Nevertheless, a number of Member States are currently significantly below that target[111] and the events in Italy seem to suggest that consumers there lack confidence in the local deposit protection arrangements to compensate them.

But it is submitted that the depositor protection argument is an insufficient reason to introduce ring-fencing across the EU; improved prudential regulation, bank recovery and resolution efforts and deposit guarantee mechanisms have, as Governor Carney suggested, significantly improved the position since the financial crisis. The depositor protection regime should continue to strengthen over the next six years and it is hard to see how the enormous cost of ring-fencing is justified.

The counter-argument from Vickers has always been that, whatever the costs to the banks of ring-fencing, they will be less than the costs to the taxpayer of a bail out.[112] Yet despite his assertion, there are other risks within the wider financial system that may prevent this

[107] The Run on the Rock
[108] DGSD 2009 (n 1)
[109] Recast DGSD 2014 (n 1).
[110] Recast DGSD 2014 Art 10(2).
[111] EBA Report (n).
[112] Vickers (n 3).

costs outcome. Even in the absence of a financial crisis, ring-fencing is likely to slow down capital flows and increase transaction costs.[113] In the context of a financial crisis, although much has been done to standardise resolution processes internationally, not all national regulators will necessarily revert to the COAGs and co-operate on the cross-border lines that were envisaged in the resolution planning stage. It would still be possible for capital to be retained in one jurisdiction and withheld from others even within a separately capitalised, ring-fenced part of a banking group, albeit that this is less likely to be a real problem where the arrangements are put in place as part of pre-resolution planning and so are transparent (as will be the case with the UK's ring-fencing regime).[114]

Another factor that will have an impact on the ultimate cost-benefit analysis of ring-fencing is bail in. Although great reliance has been placed on bail in, it is untested and, as has been identified by Zhou and others, it could result in the transfer of losses from banks to other parts of the financial system (such as pension funds or insurance companies) which may also then require government (and therefore, taxpayer) support.[115] If this is the case, even if core services are protected through ring-fencing, it will still have been as a consequence of a bail out elsewhere in the financial system and the wider objectives of the ring-fencing policy will have failed as ordinary people will still have been affected. Although it will be difficult to

[113] FSB paper (n).
[114] Problems tend to arise in cases of information asymmetry and where either home or host regulators are uncertain as to the efficacy of resolution processes in other relevant jurisdictions. See D'Hulster and Otker-Robe (n 14) 173.
[115] J. Zhou, V. Rutledge, W Bossu, M. Dobler, N. Jassaud and M. Moore 'From bail-out to bail-in: mandatory debt restructuring of systemic financial institutions' (2012) IMF Staff Discussion Note SDN/12/03, 22; David Mayes 'Bank structure and resolution' (2014) 11 Journal of International Banking and Financial Law 743A

attempt to quantify the impact of a bail in on institutional investors, more data on this would be valuable.[116]

The Vickers Report has focused squarely on trying to avoid the financial instability faced by a universal bank in the event of losses caused by its investment banking arm and has given little attention to the position of deposit-taking institutions that are not part of a universal bank. But how realistic is this this model, bearing in mind that a number of the institutions that failed during the financial crisis were not universal banks? Although Northern Rock was involved in the wholesale banking markets, it was an entirely retail deposit-taking institution as were Bradford and Bingley and Dunfermline Building Societies. Conversely, Lehmans was purely an investment bank. It is hard to see how ring-fencing would have helped any of these institutions, although the post-crisis improvement in supervisory and prudential measures would certainly have done.

There is also a school of thought that suggests that simply regulating to combat risk will not work. Persaud contends that "ring-fencing different sectors of the financial system does not make it safer. It could make it less safe by restricting natural fits between risk and risk capacity".[117] His point is that in attempting to reduce risk through regulation, the risk does not disappear, it simply translates itself into a different risk that is not necessarily anticipated. By way of example, he observes that the pre-2008 financial model was the

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[116] T. Conlon and J. Cotter have retrospectively applied the bail in framework to the European banks and concluded that depositors would not have required bail in, in 'Anatomy of a bail in' Journal of Financial Stability 15 (2014) 257. The question of the impact of that bail in on those institutions holding equity and subordinated liabilities was not been considered.

[117] Avinash Persaud 'Reinventing financial regulation: sanity is not statistical' (2015) 3 Journal of International Banking and Finance Law 134 at 135.

wrong way around: banks set capital against relatively low risk activities in compliance with Basel II but failed to set capital against high risk activities because no one had asked them to.[118] The new regulatory framework has shored up many gaps, but there are likely to be others where risks slip through.

It is significant that ring-fencing has not been identified by the FSB as a "must have" item in its list of Key Attributes. Banks need to meet the safety and soundness objectives set by regulators in order to protect consumers and the wider financial system, but it is also important to remember what banks are *for*; money tied up in regulatory initiatives is money that is taken out of the real economy and is unavailable for innovation and growth. Banks are only patchily making funds available to those who need them, as has been identified in the EU's green paper on Capital Markets Union, with many in need of credit finding that it is unavailable.[119] The focus of the Key Attributes and their implementation within the EU has been about protecting bank functions rather than the banks themselves. It remains to be seen whether the additional layer of regulation required for UK ring-fencing will make a sufficiently significant improvement to be worthwhile, even if it can help to make bank resolution processes more robust and increase the level of trust depositors have in the financial system.

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[118] Persaud (n108).
[119] European Commission Green Paper 'Building a Capital Markets Union' COM (2015) 63 final, 13.