The UK Government’s White Paper on Banking Reform

“The reforms proposed here will ensure that we meet the challenge of the British Dilemma, namely how to remain a successful global financial centre without asking tax payers to bear unacceptable risks.”

Foreword to the White Paper

The UK Government’s White Paper on banking reform, published on 14 June 2012¹, sets out proposals for implementing the recommendations of the Independent Commission on Banking (the ICB), published in September 2011 and discussed in our earlier briefing paper ‘Resolving the dilemma of British banking’².

The White Paper does not contain any draft legislation. Rather, it is the fruit of the Government’s detailed policy thinking and, by way of consultation, it asks for responses to a number of questions that remain open. The Government has undertaken an impact assessment of its proposals, which can be found in the annex to the White Paper.

It is notable that:

• much of the detail of the new regime will be left to secondary legislation and/or the rules of the FSA’s two successor regulatory authorities, especially the Prudential Regulation Authority; and

• the White Paper is more cautious than the ICB in taking steps, especially in respect of bank capital requirements, which go further than either present or likely future co-ordinated developments at global or EU level. This may be seen as a realistic recognition of the limits on the UK’s powers, a fear of undermining the UK’s competitive position, or a victory for bank lobbying; in truth it may be a combination of all three.

This introductory paper is confined to a reminder of the ICB’s main proposals and an overview of the Government’s responses as they appear in the White Paper.

¹ ‘Banking reform – delivering stability and supporting a sustainable economy’
² Searchable at www.slaughterandmay.com
STRUCTURAL REFORM

The ICB’s original proposals
The essential elements of the ring-fencing proposals arrived at by the ICB were as follows:

• The UK/EEA retail activities of UK universal banks would be wholly separated from investment banking activities, in both operational and legal terms, with retail subsidiaries having their own boards of directors, generally with a majority of independent non-executives. Non-EEA retail banking would likewise be separated from the UK/EEA retail operations but might be combined with investment banking.

• Certain activities which are vital to the real economy, such as retail and SME deposit taking and payment systems, must be located in the retail banking business.

• Other activities, such as proprietary trading, underwriting and most derivatives trading, must be located outside the retail bank (e.g. in the investment banking business) and may not be carried on by subsidiaries of the retail bank.

• A number of activities, such as banking services provided to large corporates, could be located in either business (allowing for flexibility depending, for example, on the relative size of the retail business).

• Interactions between the retail bank and the rest of its banking group, including transfers of capital and assets and the provision of support services, must be conducted on an arm’s length basis as if with an unconnected third party. Strict financial and operational exposure limits would apply to those interactions. In essence, the retail bank must be able to continue to operate following the failure of the rest of the group.

• The retail business must at all times meet regulatory capital and large exposure requirements on a standalone basis and report publicly as if it were a listed company.

Key modifications proposed in the White Paper
Broadly the Government intends to implement the ICB’s proposals in full. However there have been certain key modifications to those original proposals:

• Only accepting deposits from individuals and SMEs will be mandated as a ring-fenced activity (that is, an activity which may only be carried on by a ring-fenced bank) at the outset. Powers will be granted to mandate other activities, if deemed necessary; but the Government expects that most essential banking services provided to individuals and SMEs will as a matter of business practice be undertaken within a ring-fenced bank.

• Whilst most wholesale market activities will be prohibited for ring-fenced banks, limited wholesale market activities relating to funding, hedging and liquidity will be permitted within the ring fence.

• Ring-fenced banks will be permitted to offer “simple” derivative products to SMEs and individuals for hedging purposes.

• The Government sees a case for imposing limits on, and regulating the terms of, intra-group funding, as a ring-fenced bank will be vulnerable if funding is suddenly withdrawn because of financial difficulties outside the ring fence.
• The Government supports the strengthening of the independence of management of ring-fenced banks by the imposition of a duty on directors (possibly under the existing Approved Persons regime) to “protect the integrity of the ring fence”. This would apply to directors of a parent company as well as to those of a subsidiary ring-fenced entity.

• The Government considers that banks with individual/SME deposits below a specified threshold (suggested at this stage as £25 billion) should be exempt from the ring-fencing requirement. The White Paper suggests that such an exemption would carve out approximately 13% of the banking sector on current estimates.

In addition, the White Paper draws attention to the fact that the IMF has called for UK regulators to have greater supervisory powers in relation to the unregulated parents of banking groups. The Financial Services Bill currently before Parliament already contains proposals for new powers to be granted to the Prudential Regulation Authority and Financial Conduct Authority to take certain limited action in relation to unregulated parent undertakings, but the Government is now also going to consider the merits of providing for additional powers over unregulated parent undertakings for the purposes of delivering these structural reform proposals.

CAPITAL AND LOSS ABSORBENCY

The ICB’s original proposals

The ICB made five core recommendations on capital requirements and loss absorbency for UK banking groups:

• Capital (retail banks): Large UK retail deposit takers (that is, the five largest high street banks and the largest building society) should be required to maintain equity capital “of at least 10% of risk-weighted assets”; exceeding the minimum 7% common equity requirement under Basel III (a 4.5% hard minimum supplemented by a capital conservation buffer of 2.5%). Smaller UK retail banks would be subject to a minimum equity requirement of between 7% and 10%.

• Group capital: Both the retail and investment banking activities of large banking groups should have “primary loss-absorbing capacity” of at least 17%-20%. Under the proposals, the difference between the regulatory minimum and the 17% figure could include other regulatory capital instruments as well as so-called ‘bail-in bonds’.

• Leverage ratio: at least a 3% leverage ratio (Tier 1 capital to gross assets) should be applied to all banks, with proportionate increases (up to 4.06%) for larger banks.

• Bail-in tools: regulators should have the power, during resolution, to impose losses on unsecured debt, in a staged process which respects creditor hierarchy.

• Depositor preference: There should be a statutory preference for any deposits (retail and other) which are insured by the UK Financial Services Compensation Scheme (FSCS). The effect of this preference would be to place relevant depositor claims (or, more accurately, claims of the FSCS standing in the shoes of insured depositors) ahead of the claims of other unsecured creditors in the event of a ring-fenced bank’s failure.

3 Barclays, HSBC, Lloyds Banking Group, RBS, Santander UK and Nationwide.
Key modifications proposed in the White Paper
The Government has accepted most of the ICB’s proposals, subject to some critical modifications (or concessions):

- Capital requirements which exceed international (i.e. Basel III) requirements or local requirements will not be applied to the overseas operations of larger banks if those overseas operations do not pose a risk to UK and/or EEA financial stability.

- The Government does not intend to pursue the proposal to impose a higher leverage ratio than the 3% proposed under Basel III.

- The Government proposes to devise bail-in tools in the context of the finalisation and implementation of the EU Crisis Management Directive, which makes provision for such tools.

COMPETITION
The ICB made a number of recommendations to improve competition in the banking sector, covering:

- An enhancement to the divestiture program required of Lloyds Banking Group by the European Commission to facilitate a new entrant to the UK banking high street.

- Arrangements to make it easier for depositors to transfer their deposit accounts between banks.

- Greater transparency in the pricing of banking services.

- A duty under the new statutory framework for financial regulation in the UK for the Financial Conduct Authority to promote competition in financial services.

- Consideration to be given to referring the UK banking market to the Competition Commission if matters do not improve by 2015.

The Government has noted these themes in the White Paper but made no further specific proposals. The Government appears to consider that the competition concerns identified by the ICB are now already being adequately addressed through other legislative measures, market events or industry-led initiatives.

NEXT STEPS
The White Paper explains that ring-fencing, depositor preference, and the application of primary loss absorbing capacity will all require primary legislation. The Government intends to publish a draft Bill for pre-legislative scrutiny in the autumn.

With the exception of the provisions to address depositor preference, this will be an enabling Bill, conferring powers and duties on HM Treasury and/or the relevant UK regulators to make subsidiary legislation and rules to flesh out the legislative framework.
In relation to the ring-fencing measures, decisions with a socio-economic impact (such as which services to mandate and which to prohibit in the ring-fence) are to be delegated to the Government. The relevant regulators will be responsible for matters of a more technical nature.

The Government will need to ensure, and has stated its commitment to doing so in the White Paper, that forthcoming European legislation (particularly the proposed Capital Requirements Directive package and the recently-proposed Crisis Management Directive) does not prevent the UK from implementing these proposals.

**Timetable**

The consultation period for the White Paper closes on 6 September 2012. As mentioned above, draft legislation for pre-legislative scrutiny will follow in the autumn. The Government intends to complete all primary and secondary legislation by the end of May 2015 so that banking groups would be required to comply with the new regime by 2019.