Briefing note
September 2011

UK Independent Commission on Banking Publishes Final Report

The Independent Commission on Banking (ICB) was appointed by the UK government last year. The ICB published its Final Report on Monday 12 September. The Final Report recommends that, by early 2019, UK retail banking activities should be ring-fenced into separate subsidiaries and that both ring-fenced banks and wider financial institution groups should be subject to capital requirements that are stricter than those required by Basel III standards.

Key issues:

- UK Independent Commission on Banking has published its Final Report
- Recommendation to ring-fence UK retail banking into separate subsidiaries
- Recommendation to impose capital requirements on ring-fenced banks and other UK banks
- Recommendation for a redirection service for personal and SME current accounts

The broad content of the ICB's Final Report was foreshadowed by the ICB's Interim Report in April (see our briefing note: "The UK Independent Commission on Banking's Interim Report", April 2011). Summaries of the key proposals are set out in Boxes 1 to 3 and the rest of this briefing focuses on the features of the ICB's reports that were not expressly anticipated by the Interim Report.

Ring-fencing

As expected, the ICB recommends that banking groups should be structurally separated so as to isolate UK retail banking behind a ring-fence. The ICB has rejected stricter forms of structural separation, such as the imposition of "narrow banking" principles or the separation of retail banking into wholly separate corporate groups.

The ICB has developed a principles-based approach to indicate the desired "location" of the retail ring-fence (i.e. which customers and activities fall within the ring-fence) and the "height" of the fence (i.e. the extent to which links will be permitted to exist between entities either side of a fence). These principles are summarised in **Box 1**.

The term "retail ring-fence" is something of a misnomer, as deposit taking business for EEA SMEs (i.e. small and medium enterprises, as defined in the Companies Act 2006), as well as for individual customers must be included within a ring-fenced bank. Additionally, the ICB recommends that deposit taking and

lending business for large corporate clients (other than financial institutions) may be included within the ring-fence.

Pursuant to Principle 3, a number of “ancillary services” may fall within the ring-fence. Such ancillary services include certain activities in which the treasury function of a ring-fenced bank engages, including interest rate hedges (provided such hedging is not sold as a service to clients). This goes some way towards addressing concerns that ring-fenced banks would be prohibited from entering into derivatives that are commonly considered essential to the provision of fixed rate loan/mortgage products.

The ICB recommends that “very high net worth banking customers” may opt-out of having their deposits held within a ring-fenced bank. However, the ICB warns that stringent limits should be placed on this ability to opt-out. The ICB states that such opted-out private banking clients must, as a minimum, have adequate knowledge and experience of financial matters and have substantial liquid assets.

The exclusion of business relating to non-EEA customers (including retail customers) from ring-fenced banks will likely have significant consequences for banks with individual and corporate clients based outside the EEA (including clients based in Switzerland and the Channel Islands, as well as further afield).The ICB’s recommendations apply UK banks and UK branches of non-EEA banks. They do not however apply to the passported UK branches of EEA banks. The ICB considers whether, as an avoidance mechanism, a UK bank might relocate to an EEA member state and subsequently passport back into the UK, thereby avoiding the ring-fencing requirements, but dismisses this on the basis of perceived reputational and practical impediments.

Capital Requirements

The ICB’s capital requirement proposals are summarised in **Box 2**.

Although certain of these recommendations (such as the 7-10% equity to risk weighted assets ratio) are limited to ring- fenced banks, other requirements have a more general application to UK banks. The recommended leverage ratio applies to all UK headquartered banks (although it is only increased on a sliding scale in respect of certain ring-fenced banks), and the recommendations for primary loss-absorbing capacity and resolution buffers apply to all UK global systemically important banks.

The capital requirements exceed those required by Basel III. Basel III is being implemented in the EU through the legislative proposals collectively known as CRD IV. The proposed CRD IV text is on a maximum harmonisation basis, meaning that individual EU Member States will not in theory be able to exceed the standards required thereby. The ICB acknowledges this but insists that maximum harmonisation is not the right approach. As the CRD IV consultation and legislative process is ongoing, it remains to be seen whether, in seeking to deliver the ICB’s proposals, the UK Government attempts to align CRD IV with the ICB proposals or to challenge its maximum harmonisation status.

Depositor Preference

The ICB recommends the introduction of a depositor preference. This would require “insured depositors” (i.e. depositors benefiting from FSCS deposit protection) to rank senior to all other unsecured creditors, and creditors secured only by a floating charge on a winding up of a ring-fenced bank (it is not clear how creditors who have the benefit of a financial collateral arrangement should rank). Given that preferred depositors are likely to form the majority by value of creditors, other creditors’ (such as landlords) claims would be significantly compromised on a winding up or bank resolution.

Increasing competition in retail banking

The ICB’s proposed structural remedies (summarised in Boxes 1 and 2) are likely to have a knock-on impact on competition in banking. The ring-fencing of retail banking and increased capital requirements (in particular, those specifically for larger retail banks) are likely to increase costs for consumers, and it seems impractical for them to be borne solely by the investment banking divisions of the UK banks. The Final Report does not directly address the issue of free if-in-credit banking apart from the effect increase transparency will have on the ability to compare free accounts with those incurring a charge. Nevertheless, banks’ continued ability to offer free products despite additional costs will be likely to drive competition for customers, particularly if account switching is made easier as proposed (see **Box 3**).

Although additional Lloyds divestments have not been required, the limits the ICB has proposed on the funding and market share (effectively between 6% and 14% of the market for personal current accounts) may impact upon the pool of potential bidders. By insisting on a strong challenger, rather than additional Lloyds’ divestments, the ICB has eliminated the immediate legal uncertainty arising from its previous suggestion that a Competition Commission market investigation into retail and SME markets could be triggered by an unsatisfactory outcome to the divestiture. The ICB has postponed the decision on a reference to the Competition Commission until 2015 and made the decision dependent on the non- fulfilment of one or more of the suggested measures summarised in Box 3, rather than just the outcome of the Lloyds disposals.

Additional issues arise from the ICB's insistence that promoting competition be mandated as a clear primary duty of the Financial Conduct Authority (FCA). This has the potential to lead to a conflict between the new agency's consumer protection and competition promotion duties. It is also unclear how an FCA with competition powers would fit into the current concurrency regime delineating the various power of the Office of Fair Trading, Competition Commission and various sectoral regulators, particularly given the ongoing reforms to the UK's competition regime.

Implementation and Timing

The ICB expects its structural and capital proposals to be implemented by early 2019, tying in with the deadline for full implementation of the Basel III reforms. However, as described at Box 3, the ICB recommends that its proposal for redirection services should be introduced as soon as possible.

Box 1: Ring-fencing Principles

Principles 1 to 3 set out the "location" and Principles 4 and 5 set out the "height" of the fence.

Principle 1: Mandated Services must be provided by a ring-fenced bank
Mandated Services are services where a temporary failure to the provision of such service resulting from the failure of a bank has significant economic costs and where the customers are not well equipped to plan for such an interruption.

Mandated Services currently comprise the taking of deposits from, and the provision of overdrafts to, individuals and SMEs.

Principle 2: Prohibited services must not be provided by a ring-fenced bank
Prohibited Services are services which meet any of the following criteria:

(a) make it significantly harder/more costly to resolve a ring-fenced bank;

(b) directly increase a ring-fenced bank's exposure to global financial markets;

(c) involve the ring-fenced bank taking risk and is not integral to provision of payment services or the direct intermediation of funds between savers and borrowers within the non-financial sector; or

(d) in any other way threaten the objectives of the ring fence.

Prohibited Services include (without limitation), services to customers outside the EEA, services resulting in trading book assets, services resulting in requirement to hold regulatory capital against market risk, most derivatives business, secondary market activities.

Principle 3: Ancillary activities
A ring-fenced bank should only be involved in the provision of services which are not prohibited and those ancillary activities necessary for the efficient provision of such services.

Such ancillary activities include support functions such as employing staff and owning/procuring infrastructure and financial activities that are strictly required for the purposes of its treasury function.

Principle 4: Legal and operational risks
Where a ring-fenced bank is part of a wider corporate group, it should be possible to isolate it from the rest of the group in a matter of days and continue the provision of its services without providing solvency support.

Ring fenced banks should be separate legal entities. Financial organisations owned or partly owned by a ring-fenced bank must themselves only conduct activities permitted within a ring-fenced bank. The ring-fenced bank must have continuous access to all resources required to continue its activities, irrespective of the financial health of the rest of the group and it should be either a direct member of all the payment systems it uses or should use another ring-fenced bank as its agent.

Principle 5: Economic links
Where a ring-fenced bank is part of a wider corporate group, its relationships with entities in that group should be conducted on a third party basis and it should not be dependent for its solvency or liquidity on the continued financial health of the rest of its group. Generally, transactions with other group members should be carried out on an arm's length basis. The ring-fenced bank should have an independent board of directors. Ring-fenced banks should make certain regulatory disclosures on a solo basis as if it were independently listed on the LSE.

Box 2: Capital

Equity

Ring-fenced banks with a ratio of risk weighted assets (RWAs) to UK GDP of at least 3% should have an equity-to-RWAs ratio of at least 10%, with a sliding scale from 7% to 10% for ring-fenced banks with a ratio of RWAs to UK GDP of between 1% and 3%.

Leverage ratio

All UK-headquartered banks and all ring-fenced banks should maintain a Tier 1 leverage ratio of at least 3%, increasing on a sliding scale for all ring-fenced banks with a RWAs-to-UK GDP of 1% or more, up to 4.06% at a RWAs-to-UK GDP ratio of 3%.

Bail-in

The relevant "resolution authorities" should have a primary bail-in power allowing them to impose losses on bail-in bonds in resolution before imposing losses on other non-capital, non-subordinated liabilities, and a secondary bail-in power to enable them to impose losses on all other unsecured liabilities, if necessary.

Depositor preference

In insolvency and resolution scenarios, all insured depositors should rank ahead of creditors which are unsecured or only secured with a floating charge.

Primary loss-absorbing capacity

UK global systemically important banks with a 2.5% G-SIB surcharge and ring-fenced banks with a ratio of RWAs to UK GDP of at least 3% should have primary loss-absorbing capacity (i.e. equity and, subject to regulatory approval other forms of capital such as bail-in bonds and contingent capital) equal to at least 17% of RWAs, with a sliding scale from 10.5% to 17% for smaller UK G-SIBs.

Resolution buffer

If the supervisor of any ring-fenced bank with a ratio of RWAs to UK GDP of at least 1% or of any G-SIB has concerns about its ability to be resolved at minimum risk to the public purse, it should be able to require the bank to have additional primary loss-absorbing capacity of up to 3% of RWAs and should have discretion in relation to the amount and form of the additional capacity, to which entities in a group it should apply and whether it should apply on a (sub-)consolidated or a solo basis.

Box 3: Competition

The ICB believes the Final Report's financial stability recommendations (summarised in Boxes 1 and 2) are pro-competitive, in that they remove the implicit government guarantee for banks, and will additionally create an framework in which "ill-directed" competition through escalating risk taking would be discouraged. The Final Report further proposes a number of measures specifically targeted to improve competition in UK retail banking, leaving aside any consideration of competition in wholesale and investment banking.

On the demand side, the ICB concludes that consumers are faced with unclear information regarding their banking options (including charges) and difficulty in switching accounts between banks. On the supply side, the crisis has led to the disappearance of a number of challengers, resulting in a more highly concentrated market in which the largest four banks (Barclays, HSBC, Lloyds Banking Group and Royal Bank of Scotland) take in over three-quarters of deposits for both personal current accounts and SME accounts. Barriers to entry are a further complication - it is difficult for potential challengers to acquire the established branch network that consumers prefer.

Creating a credible challenger

In its previous Interim Report the ICB expressed its concern that the business to be divested by Lloyds Banking Group (as part of the sale of assets required by the European Commission's 2009 State aid decision) would not have a sufficient impact on competition in UK retail banking markets. In its Final Report, the ICB reaffirms its support for the "substantial enhancement" of the divestiture, but stops short of recommending an additional number of branches to be divested or an increase in the number of personal current accounts to be sold to a prospective challenger. Rather, the Final Report focuses on the viability of the divested business, recommending that the UK Government seek agreement with Lloyds Banking Group to ensure that the divestiture leads to the emergence of a strong challenger, with sufficient funding (based on loan-to-deposit ratio) and at least a 6% share of the personal current account market.

Switching and transparency

To overcome a perceived difficulty in switching accounts, which hinders effective competition, the ICB recommends that a redirection service for personal and SME current accounts should be introduced as soon as possible. Such a service should enable consumers to transfer accounts from bank to bank within seven working days and continue to do so seamlessly for at least a year. Responses to the consultation on the Interim Report have led the ICB to conclude that such a system can be put in place without undue cost. The ICB has concluded that bank account number portability, a previously considered option, would involve more uncertain costs and benefits by comparison, but that the option should be re-evaluated in the future.

The ICB believes that improvements in switching will only benefit bank consumers if they are well informed as to the available options. Transparency would also encourage banks to meet consumers' needs at competitive prices. The Final Report's recommendations include regulatory action to make current accounts more easily comparable and/or require a standardised current account, along with a requirement on banks to clearly state the elements of the prices they charge, including displaying interest foregone on current account statements.

Role of the FCA

The ICB feels that the problems with competition in the banking sector are due in part to competition not being central to financial regulation, and that this should be remedied as part of the current reform of the UK financial regulatory regime. Promoting ease of switching, improved price transparency and reduced barriers to entry for new banks are examples of how the FCA could make a difference to retail customers if it were given a pro-competition mandate. The Final Report therefore recommends that the FCA should have a clear primary duty to promote competition and that its current proposed statement of objectives should be strengthened to reflect this.

Clifford Chance contacts

If you would like to know more about the subjects covered in this publication or our services, please contact:

Chris Bates
Partner
T: +44 20 7006 1041
E: chris.bates@cliffordchance.com

Oliver Bretz
Partner
T: +44 20 7006 8374
E: oliver.bretz@cliffordchance.com

Simon Gleeson
Partner
T: +44 20 7006 4979
E: simon.gleeson@cliffordchance.com

Greg Olsen
Partner
T: +44 20 7006 2327
E: greg.olsen@cliffordchance.com

Charles Morris
Senior Associate
T: +44 20 7006 8288
E: charles.morris@cliffordchance.com

Michael Rueter
Lawyer
T: +44 20 7006 2855
E: michael.rueter@cliffordchance.com