Ring-fencing Banks: who is doing it, why and will it work?

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Introduction

The role of banks in the global financial crisis has generated significant public anger. The massive bailout using billions of public sector funds has been seen as something which must not be allowed to happen again. One area which has been the focus of serious criticism is what is seen as the reckless investment banking activity of many of the banks. This has led to calls for the retail side of banking (in other words, the traditional deposit-taking and lending aspects) to be separated from the riskier activities of the investment banking side.

Since then, the banking part of the financial system has been strengthened as banks are now required to hold increased levels of capital[1] and formal resolution mechanisms for failing banks and financial institutions have been introduced, bringing further improvements.[2] The new EU bank resolution regime specifically seeks to overcome some of the difficulties that are associated with resolving failing institutions where they are based across more than one Member State. At the same time, efforts are being made to harmonise depositor protection in the EU. All this work is the result of a significant effort from the international financial community in an attempt to address the problem of banks which have been considered "too big to fail".[3] There is another proposed reform which has become known as 'ring-fencing' and which is the focus of this article.

The role of ring-fencing in managing risk

Ring-fencing can be seen as a mechanism for reducing the overall risk within a firm through the reallocation of that risk and can, according to Schwarcz, be used for a number of purposes.[4] It can be used to improve creditworthiness; 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; where it is necessary to preserve an entity's business and assets; and to assist the smooth resolution of a failing bank. In the context of this article, ring-fencing means the separation of retail banking activities (essentially those activities undertaken by consumers and small businesses) from high risk investment banking activities carried out within the same bank. The separation of these activities is intended to limit the exposure of the retail banking part of the organisation, so that the interests of consumers are protected. It is not a new idea, as the separation of investment banking activities from commercial banking activities was first introduced in the US in the Glass-Steagall Act of 1933.

Before the financial crisis of 2007, universal banking was considered to be the most efficient way to provide banking services.[5] Banks benefited from economies of scale by being able to offer all their

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[1] Implemented in the EU through CRD IV, which comprises the EU Capital Requirements Regulation ("CRR") [2013] OJ L 176/1 and the EU Capital Requirements Directive [2013] OJ L 176/388.

[2] In the UK, through the Banking Act 2009 and within the EU through the Bank Recovery and Resolution Directive [2014] OJ 2 173/190 ("BRRD") and the Single Resolution Mechanism [2014] OJ 2 225/1.

[3] Whereby a global systemically important bank (hereafter "G-SIB") has to be supported with government funds because its failure would trigger the failure of other banks and financial institutions (hereafter "TBTF").

[4] Steven L. Schwarcz 'Ring-Fencing' (2014) 87 Southern California Law Review 69, 72.

[5] The Independent Commission on Banking 'Final Report Recommendations' September (2011), hereafter the Vickers Report. (Available at http://webarchive.nationalarchives.gov.uk, accessed 23 June 2015) See also

services through a single bank (something which was also useful for clients). There were also capital requirements benefits for banks. Instead of the bank's capital requirements being based on the risks generated by the specific line of work that each part of the bank undertook, they could be based on the risks generated by the consolidated banking group. It was thought that diversification of risk across various business lines reduced funding costs and that the economies of scale meant additional savings.

In the years preceding the financial crisis, the banking world had been gradually changing. Banks had started to use securitisation more widely and had increased their involvement in the securities markets. This led to the emergence of a few extremely powerful G-SIBs.[6] The investment banking activities of these G-SIBs meant that they were closely connected to the shadow banking markets and this connection was largely responsible for their ultimate instability in the financial crisis.

Shadow banking is, essentially, the provision of credit intermediation services by non-bank financial institutions.[7] The term applies to a range of activities which enable funds to be made available in the market place through institutions other than banks and so it plays an important role in the economy. The significance of this at the time of the financial crisis was that non-banks were not regulated as banks were, nor were they subject to the same prudential requirements.[8] As the G-SIBs became more involved in shadow banking activities through, for example, becoming prime brokers and providing services to hedge funds, they increased their exposure to less regulated, non-bank counterparties. Many of the market and liquidity risks that lay behind their transactions were not explicit and this hid the extent of the banks' exposures. This, in turn, had an impact on their financial stability.[9]

It can be seen from this that, in the context of a universal bank, the entire bank is exposed to the risks borne by its investment banking work. Equally, the investment banking arm is exposed to the risks borne by the deposit-taking side, albeit that the risks generated by the deposit-taking work of these banks did not appear to be significant in the crisis. The consequence is that a failure by a bank to meet its high-risk investment banking obligations could result in the deposits of consumers and small businesses being put at risk and raise the spectre of a bank run. Although UK banks Barclays and HSBC survived the financial crisis without UK government financial support, RBS and HBOS did not, having placed excessive reliance on their non-core banking activities.

The Vickers Report was one of a number of reports into the UK banking crisis and recommended that retail bank functions should be separated from investment bank functions within a universal bank.

The UK: The Vickers Report and Subsequent Developments

The Vickers Report identified a number of principles that should be adopted for the purpose of creating a ring-fence that would separate essential retail banking activities from high risk investment

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Pentti Hakkarainen: Debate on 'Re-evaluating the universal banking model: Can the Volcker, Vickers or Liikanen rules make banks safer? (Available at http://www.bis.org/review/r130305h.pdf, accessed 7 December 2015).

[6] Erkki Liikanen 'Final Report of the High Level Expert Group on reforming the structure of the EU banking sector' Brussels, October (2012).

[7] 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.

[8] 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.

[9] Ibid (n 8).

banking activities. The ring-fence would provide insulation from financial system shocks and ensure that essential services, such as making payments and allowing depositors access to their savings, would not be affected. The existence of a ring-fence should do away with the need to rely on guarantees from the government and make it more likely that financially challenged banks could be successfully resolved without the need for public funds.[10]

The fence's location – where should it be?

Vickers suggested that there should be a concept of "mandated services" and that retail deposits and the provision of overdrafts to individuals and small and medium-sized businesses ('SMEs) should come within this definition. Vickers also recognised that it is vital to protect the payment system. There is nothing here that is controversial as there is no doubt that these basic banking services are now considered to be essential to modern society and indeed can be described as a form of public utility.[11] Interruptions, even temporary, would have significant ramifications for the wider economy and the population at large.[12]

The first principle set out in the Vickers Report was that "only ring-fenced banks should be granted permission by the UK regulator to provide mandated services".[13] This would apply to UK banks which take deposits but which were also part of a larger banking entity regardless of whether the bank was registered in the UK or elsewhere.[14] The second principle was concerned with those activities which a ring fenced bank would not be allowed to participate in. Not surprisingly these are activities which would expose the bank to greater risks.[15]

The legislative response to the Vickers Report in the UK, the Financial Services (Banking Reform) Act 2013 ("FSBRA 2013"), has followed the recommendations of the Vickers Report with regard to where the fence should be. A ring-fenced body will be a bank which has been incorporated in the UK and which has been granted authorisation by the regulator to undertake a core activity.[16] Smaller banks will not be required to comply with the ring-fencing rules as any bank with less than £25 billion in assets will not be included in ring-fencing.[17]

What is probably most important with regard to where the ring-fence is located is to look at those activities which are prohibited or, to use the words of the statute, excluded.[18] This goes to very heart of the idea of ring-fencing and, not surprisingly, dealing in investments as principal is specifically excluded. The Treasury is allowed to make orders overriding this exclusion, however, and this is arguably a matter of concern. Whether or not the Treasury will do this in practice remains to be seen. Similarly, the Treasury is also permitted to add to the list of excluded activities.

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[10] Vickers Report (n 5) 35.

[11] See the discussion in the House of Commons Treasury Committee Fifth Report of Session 'The Run on the Rock' (1) (2008) 75.

[12] Vickers Report (n 5) 38.

[13] This definition included building societies, Vickers Report (n 5) 38.

[14] Vickers Report (n 5) 39.

[15] Ibid (n 5) 52-53.

[16] Under Part 4A of Financial Services and Markets Act 2000 ("FSMA").

[17] 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.

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

How high should the fence be?

Having considered the location of the fence, it is necessary to consider how high the fence should be. Principle 4 of the Vickers Report considered both the operational and the legal links which would exist between the ring-fenced bank and the rest of the banking group.

Vickers recognised the importance of ensuring that ring-fenced activities would be able to continue in the event that the non-ring-fenced part of the group should fail (addressed in principle 5). This is, arguably, fundamental if ring-fencing is going to work. A specific measure designed to avoid operational and liquidity risk is that any payment system must be accessed only through a ring-fenced bank; in this way, there can be no contagion spread from losses in the bank's non-ring-fenced part.[19]

Another unsurprising requirement is that the ring-fenced and non-ring-fenced parts of the group should only deal with each other on an arms-length basis. This makes sense as does the requirement that the ring-fenced part will have to be fully compliant from a regulatory perspective, particularly with regard to capital and liquidity.

Much of the Vickers Report has been adopted through FSBRA 2013 and the principles are broadly agreed, albeit that the detail remains subject to further consultation. With regard to the capitalisation of ring-fenced bodies, it is envisaged that there will be sub-consolidation within the ring-fenced part of the bank.[20]

Thus the UK approach to ring-fencing is not to attempt to have a total separation of deposit-taking banks and investment banks, but to allow banking groups to continue to offer a wide range of services albeit with certain parts of the group being ring-fenced. It follows from this that any subsidiaries of ring-fenced bodies will only be able to conduct ring-fenced activities.[21]

There is an element of geographical ring-fencing in that a ring-fenced body cannot have a branch or a significant interest in an entity carrying out regulated activities beyond the EEA.[22] This restriction would extend to a UK subsidiary of a foreign bank if it fell within the £25bn threshold on deposits. It would not apply to a UK branch of a foreign bank, however. A likely outcome is that non-EEA entities will choose to create a UK subsidiary if they want to take on any kind of ring-fenced work.

In order to ensure that the ring-fence is maintained on a day-to-day basis, the ring-fencing provisions require the board of the ring-fenced entity to be constituted independently of its UK holding company. The Prudential Regulation Authority (the "PRA"), as the main bank regulator, is in the process of finalising the rules as to the composition of the board, but they are intended to prevent the ultimate holding company from being in a position to influence the direction of the ring-fenced

[19] Vickers Report (n 5) 67.

[20] Prudential Regulation Authority Consultation Paper CP19/14 'The implementation of ring-fencing; consultation on legal structure, governance and the continuity of services and facilities' October (2014), Prudential Regulation Authority Policy Statement PS10/15 'The implementation of ring-fencing: legal structure, governance and the continuity of services and facilities' May (2015) available at www.bankofengland.co.uk. (Accessed 26 July 2015) and Prudential Regulation Authority Consultation Paper CP37/15 12. 'The implementation of ring-fencing; prudential requirements, intragroup arrangements and use of financial markets infrastructures' October (2015).

[21] Ibid (n 20).

[22] SI 2014/2080 The Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order Article 20.

entity in a manner that might require it to breach the ring-fence. Directors of a ring-fenced entity cannot also be directors of a non-ring-fenced company within the group, with a view to strengthening the degree of separation from intra-group influences.[23] It is not clear how effective these provisions will be; concerns have been raised as to whether a subsidiary can realistically avoid pressure from its ultimate parent and whether a parent company would want to have a subsidiary that acted entirely independently of it.[24]

Other provisions that are designed to strengthen the independence of the ring-fenced entity include the introduction of separate risk and remuneration committees for the ring-fenced entities. In addition, pension liabilities will be separated to ensure that a ring-fenced entity could not assume the liabilities of a non-ring-fenced entity.[25]

Ultimately, it will be the responsibility of the directors of the ring-fenced body to achieve the ring-fencing objectives. Ring-fenced bodies will be monitored by the PRA and their directors must work closely with the PRA to ensure that the ring-fence is maintained.[26] There is a sanction: if the PRA is not satisfied that the ring-fenced body is able to act independently, it can restructure the group. The PRA can also exercise these powers in the event of the insolvency of another member of the group if the insolvency means that the necessary services to enable the ring-fenced body to continue its core activities are no longer available.[27]

Developments in the EU

The Liikanen Report was published in October 2012 and the objectives it set for structural reform were very similar to Vickers.[28] It took the view that it is important to ensure that high risk activities and proprietary trading should not be a large share of a deposit-taking bank's business. If such a situation were to arise, the trading should either stop or be transferred to another institution. Liikanen, like Vickers, regarded structural reform as only part of the solution in combination with other measures such as effective resolution plans, bail in, amendments to risk weighting and improved corporate governance in the banking industry.[29] Some Member States (notably France and Germany), have already implemented their own ring-fencing arrangements which are broadly based on the recommendations in the Likkanen Report.[30]

A proposal has been made for EU ring-fencing, or structural separation, which would apply to EU G-SIFIs and which will prohibit proprietary trading and certain other trading activities.[31] It would cover EU credit institutions, including EU parents, subsidiaries and branches in third countries as well as

[23] PRA CP19/14 (n 20) Appendix 4.
[24] Discussed in the House of Lords Economic Affairs Committee on 30 June 2015. Lord Lamont asked "why own something you can't control?" Parliamentlivetv http://parliament live.tv/event/index/2019e0ca-4235-4853-8c17-af30b00f3ee3?in=15:36:33 at approximately 16.00. (Accessed 29 July 2015).
[25] FSBRA 2013 section 4(1) inserting new FSMA section 142W, FSMA 2000 (Banking Reform) (Pensions) Regulations 2015, SI 2015/547.
[26] PRA PS10/15 (n 20).
[27] FSBRA 2013 section 4(1) inserting new FSMA section 142K.

[28] Liikanen Report (n 6) pvi.
[29] Ibid (n 6) piii.
[30] See the preamble to the EU '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).
[31] Ibid (n 30). The prohibition is set out in Article 2.

subsidiaries and branches of banks established in third countries.[32] One of the aims of the EU proposal is to ensure that it will not be possible to take advantage of geography for the purposes of regulatory arbitrage or for banks to move certain business activities to non-EU jurisdictions in an attempt to escape ring-fencing.[33] The process of implementing the EU ring-fencing proposals has stalled, which suggests a reluctance on the part of some Member States to see them introduced.[34] It seems likely that this is due to the fact that ring-fencing legislation that already exists in Eurozone Member States would be superseded by the proposed legislation even though the UK's ring-fencing arrangements would be allowed to remain in place.

The US

The US had traditionally separated high risk banking activities conducted by investment banks from commercial banking activities under the 1933 Glass-Steagall Act. This changed in 1999 when the Glass-Steagall legislation was abolished as the markets became increasingly liberalised. In the immediate aftermath of the financial crisis, the Volcker Rule was introduced specifically to prohibit deposit-taking banks from taking part in proprietary trading.[35] There have been some difficulties associated with the scope of the rule and what falls within the definition of "proprietary trading", but it is clear that deposit-taking banks are not permitted to trade as principal in high risk activities. There are some similarities with the UK regime and the EU proposals, in that exemptions exist to enable customers to access low risk hedging arrangements.

Australia and New Zealand

Taking a differing view, the Reserve Bank of Australia has indicated that, in its opinion, structural separation is not needed.[36] This view has been accepted by the Australian government as there has been no recommendation to implement ring-fencing following its recent Financial System Inquiry.[37] The Australian approach is that financial stability will be achieved by adopting financial services industry best practice. Regulatory processes should be capable of ensuring that the risks associated with trading activities are effectively managed and that, coupled with sound prudential regulation,

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[32] Ibid (n 30) Article 3.
[33] Ibid (n 30) 5.
[34] 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 5 August 2015).

[35] Section 619 Dodd-Frank Wall Street Reform and Consumer Protection Act (US) amending the Bank Holding Company Act of 1956 (US).
[36] Reserve Bank of Australia Supplementary Submission to the Financial System Inquiry (August 2014) at 3.4. http://www.rba.gov.au/publications/submissions/fin-sys-inquiry-201408/crisis-management-resolution.html accessed 5 August 2015.
[37] Response of the Australian Government to the Financial Systems Inquiry 20 October 2015. Available at: http://www.treasury.gov.au/PublicationsAndMedia/Publications/2015/Govt-response-to-the-FSI (accessed 20 October 2015).

should be sufficient.[38] There is virtually no discussion of ring-fencing by the New Zealand banks; it is likely that this is because there was limited impact in New Zealand from the financial crisis.

Some final remarks

The UK has taken the decision that ring-fencing is a vital and necessary component to ensure the continuity of banking services in an insolvent banking group and in achieving the Vickers objectives. By ensuring separate and adequate capitalisation the ring-fenced entity is strengthened and this will be an important component in helping to protect core services should there be any financial turbulence elsewhere in the group. This should also assist in the prevention of contagion. Ring-fencing should also assist in facilitating resolution, since the pre-resolution separation of business lines at an operational and economic level should help speed up any future resolution process. However, it is far from certain 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. As avoiding the need for any further injections of public money is one of the major objectives of introducing such a policy this is clearly an important issue but one which can only be judged if there is a crisis at a G-SIB.

One of the criticisms by the banking industry is that ring-fencing will be very expensive with ongoing costs for the banks estimated to be somewhere between £1.7bn and £4.4bn per year and the financial costs are not going to spread evenly as it will, of course, depend on the types and extent of its activities.[39] Many in the banking industry have questioned the need to bring in a system of ring-fencing at a time when banks are having to deal with so many other issues.

As has already been seen Australia has taken the decision not to introduce ring-fence and has made some persuasive arguments for managing without it. Nonetheless, Vickers has maintained that the costs of ring-fencing would be much less than the costs of having to bail-out an insolvent bank with the use of public funds.[40] Regardless of which is the better approach, the decision has been taken in the UK to go down the ring-fencing route and the rest of the EU may yet decide to follow.

While this paper has focused only on ring-fencing it should not be forgotten that when it is introduced it will only be one part of the wider financial sector safety-net. How useful it will be can only be tested if there is a future banking crisis involving a banking group which has a ring-fenced entity. Only then will it be possible to properly assess the role played by the ring-fence.

[38] Australian Government (The Treasury) Financial Systems Inquiry "Themes of Report" at "Resilience". Available at: http://fsi.gov.au/publications/final-report/overview/themes-of-this-report (accessed 5 August 2015).

[39] 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).

[40] Vickers (n 5).