

Insight: Regulatory

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The UK Government's response to the Independent Commission on Banking

In our client alert of September 2011 (please click [here](#) for your copy), we discussed the Final Report of the Independent Commission on Banking ("ICB")¹. The ICB made recommendations to the UK Government for reforms to the UK banking sector in three main areas:

- retail ring-fencing;
- requirements for additional and more loss-absorbent capital; and
- measures to enhance competition.

On 19 December 2011, the UK Government published its official response to the ICB². This sets out the Government's position on the ICB's main recommendations and gives an indication of its legislative plans. This client alert provides an overview of the Government's response.

Ring-fencing

One of the ICB's main proposals was to ring-fence the retail operations of UK banks. The Government broadly endorses the ICB's retail ring-fencing recommendations, but without following them to the letter. The Government also identifies a number of issues to be explored further.

Position of ring-fence

The ICB draws a distinction between mandatory services, which would have to be within the ring-fence, prohibited services which would have to be outside the ring-fence and permitted and ancillary activities, which could be on either side of the ring fence.

The UK Government will undertake further analysis on specific issues raised by this taxonomy. These include, for example, the range of mandatory services and the definitions of small and medium-sized enterprises and private banking to be used for determining it; the defining features of prohibited services, particularly the characteristics of financial institutions that may not be permitted as counterparties of ring-fenced banks, the characteristics of products prohibited by reference to their function and the approach to cross-border activities and clients; and the use of a backstop limit on the proportion of wholesale funding permitted for a ring-fenced bank in connection with ancillary services.



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¹ Available at <http://bankingcommission.independent.gov.uk/>.

² Available at http://www.hm-treasury.gov.uk/fin_stability_regreform_icb.htm.

Height of ring-fence

The ICB proposed that the ring-fenced bank should be legally and operationally independent from the rest of the corporate group to which it belongs. In addition, the ring-fenced bank should not economically depend for its liquidity and solvency on the financial health of the rest of the corporate group.

The Government will undertake further work to determine the extent of operational separability required for effective ring-fencing as well as the appropriate restrictions on ownership by ring-fenced banks of other financial entities. The Government will also consult on the detailed regulatory and governance requirements for ensuring that a ring-fenced bank has the requisite economic independence from its corporate group. In this context, the Government would like to explore, among other issues, whether it may be appropriate to impose limits on exposures from the rest of the corporate group to the ring-fenced bank rather than only on exposures from the ring-fenced bank to the rest of the group.

De minimis exemption

The ICB was not persuaded that de minimis exemptions from the ring-fencing requirements should be made available. The Government, on the other hand, will further examine the case for de minimis exemptions. In particular, the Government will consider exemptions for banks below a certain size. The Government is more sceptical about de minimis exemptions for entities that undertake a small amount of either mandated or prohibited services or for individual transactions below a certain threshold but will undertake further analysis on these options as well.

Additional and more loss-absorbent capital

Going beyond the Basel III standards, the ICB recommended additional equity capital requirements and a higher leverage ratio for certain ring-fenced banks, primary loss-absorbent capacity requirements and, potentially, a resolution buffer for certain UK banks and ring-fenced banks, primary and secondary bail-in powers for resolution authorities and a form of depositor preference. The Government's response to this package of reforms is more open.

Additional equity requirements

The Government supports the ICB's recommendation that certain UK ring-fenced banks should be subject to additional equity requirements. It also agrees that an additional equity buffer of 3% of risk weighted assets would be appropriate for the largest ring-fenced banks, with a smaller buffer for smaller ring-fenced banks. However, it plans to undertake further analysis on the methodology to be used for calibrating the ring-fence buffer to different banks. This would take account of recent international initiatives such as forthcoming work by the Financial Stability Board on identifying domestic systemically important banks.

Leverage ratio

The Government agrees with the ICB that UK ring-fenced banks should meet the Basel III 3% leverage ratio on a solo basis. However, the Government believes that further analysis is required to determine whether this leverage ratio should be increased for the largest ring-fenced banks, as recommended by the ICB.

Bail-in powers for resolution authorities

The Government agrees that the resolution authorities should be given a statutory bail-in power. It also sees merit in the idea of distinguishing between financial instruments subject to primary bail-in and other financial instruments subject to

secondary bail-in, i.e. only if still necessary after primary bail-in. However, the Government believes that further analysis is required on what instruments should be placed in which of these two categories.

More generally, the Government is in favour of extending the current resolution regime to investment firms and financial holding companies in addition to deposit-taking institutions. Work is also in progress also internationally and at EU level to develop such a wider resolution regime. A bail-in mechanism would be only one among several possible resolution tools and would need to be considered further in light of EU and international regulatory developments.

Primary loss-absorbing capacity

The Government agrees with the ICB that UK-headquartered global systemically important banks ("G-SIBs") and UK ring-fenced banks should hold primary loss-absorbing capacity consisting of regulatory capital instruments and long-term unsecured debt subject to primary bail-in. The Government also considers that 17% of risk-weighted assets is an appropriate level of primary loss-absorbing capacity for the largest banks. The Government believes that further work on the calibration of primary loss-absorbing capital to smaller banks is required.

In a major departure from the recommendations of the ICB, the Government proposes a partial exemption from the requirement for primary loss-absorbing capacity for UK-headquartered G-SIBs. They will not have to hold primary loss-absorbing capacity in respect of their non-UK operations if it can be shown that these do not pose a risk to UK financial stability and thus to UK taxpayers. Relevant evidence might include, for example, suitable plans for the resolution of non-UK operations separately from the resolution of UK operations.

Resolution buffer

The Government agrees with the ICB that supervisors should be able to impose a resolution buffer consisting of additional primary loss-absorbing capacity on UK headquartered G-SIBs and UK ring-fenced banks if there are concerns about their ability to be resolved. It also considers that 0%-3% of risk-weighted assets is likely to be an appropriate range for such a resolution buffer.

Depositor preference

The Government is broadly in favour of some form of depositor preference. However, it will carry out further analysis and consultation on its scope, including on whether it should extend to all deposits or be limited to deposits insured by the Financial Services Compensation Scheme ("FSCS") or some other subset of deposits.

Competition

The ICB made a number of recommendations for enhancing competition in the UK banking sector. The Government has only partially followed the ICB's advice.

Divestment by Lloyds Banking Group

The ICB recommended that the Government should seek an enhancement of the planned divestment by Lloyds Banking Group to enable the divested entity to become a credible competitor in the UK retail banking market. In its response, the Government notes that its 40.2% stake in Lloyds Banking Group does not allow it to give directions to its

board of directors. More generally, it is the Government's policy to manage its investments in UK financial institutions on a commercial basis. Therefore, it will not, in its capacity as shareholder, negotiate for an enhanced divestment by Lloyds Banking Group.

Switching and transparency

The ICB proposed the introduction of a redirection service for credits and debits linked to personal and SME current accounts in order to facilitate switching by September 2013. The banking industry has in fact already committed to implementing this recommendation. HM Treasury will monitor the progress of this project.

The ICB recommended measures to enhance transparency in UK retail banking. In November 2011, the Government announced an agreement with five retail banks which would give consumers more information to assist them in minimising their charges. The Government – as well as the OFT and Financial Conduct Authority ("FCA"), one of the new financial regulatory bodies envisaged in the Financial Services Bill – will consider further how best to promote transparency.

The FCA's competition mandate

The Government has followed the ICB's recommendation to give the proposed FCA a clearer competition remit. In particular, the Financial Services Bill introduced to parliament on 26 January 2011³ recasts the "efficiency and choice" operational objective that was originally envisaged for the FCA as "promoting effective competition in the interests of consumers".

Next steps

The Government is planning to publish a White Paper in the first quarter of 2012 with further detail on the implementation of the proposed changes to the UK banking sector. The Response already indicates that the Government favours a phased implementation process. Legislation relating to the ring fence is due to be passed in May 2015 and banks will be expected to comply as soon as practically possible thereafter. Other changes would be completed by 2019, in line with the ICB's recommendations.

In parallel, the Government will negotiate at EU level for more discretion for Member States to impose regulatory capital requirements above those set out in the European Commission's legislative proposals for a CRD IV package. The aim is to ensure, to the extent possible, that the proposed additional capital requirements for UK banks are consistent with the CRD IV package in its final form. Apart from the CRD IV package, the European Commission forthcoming legislative proposals on crisis management in the financial sector will also have implications for the Government's legislative plans, for example in relation to bail-in powers for resolution authorities. Therefore, the proposed reforms of the UK retail banking sector have to be considered in conjunction with legislative developments in the EU.

³ Available at <http://services.parliament.uk/bills/2010-11/financialservices/documents.html>.