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The Vickers Report and the UK Government's Response: What the Recommendations Mean for the Future of Banking in the UK

The final report of the UK's Independent Commission on Banking, chaired by Sir John Vickers, was published on 12 September 2011. Its recommendations include ring-fencing UK banks' retail banking operations, higher capital requirements for UK retail banks, preferential status for insured deposits in a bank insolvency and measures to increase competition in the UK banking sector. The UK government issued its formal response on 19 December 2011 and has indicated it will implement most of the recommendations. This memorandum summarises the key recommendations and their likely impact, in light of the UK government's response.

Introduction

The Independent Commission on Banking (the "**Vickers Commission**") was set up by the UK government to make recommendations for the reform of the UK banking sector, with a view to reducing systemic risk, mitigating moral hazard and reducing the likelihood and impact of firm failures. The Vickers Commission was also asked to consider competition in the UK banking sector.

The Vickers Commission published an Interim Report on 11 April 2011, which set out its provisional views. Having considered the responses to its Interim Report, the Vickers Commission set out its final recommendations in a paper now known as the Vickers Report. [1] The UK government published its formal response to the Vickers Report on 23 December 2011 (the "**UK Government Response**") and has agreed with most of the recommendations made by the Vickers Commission.[2] However, some subtle but significant differences are evident from the UK Government Response and are discussed below. The UK Government Response also gives a further indication of the likely timetable for implementation of the recommendations.

For the purposes of the Vickers Report, a UK bank is described as anyone carrying on a banking business as a distinct legal entity with permission from the UK regulator, so it includes any standalone UK bank, any UK bank which is part of

[1] A full copy of both reports can be obtained at http://www.bankingcommission.independent.gov.uk.

[2] A copy can be obtained at http://www.hm-treasury.gov.uk/fin_stability_regreform_icb.htm.

a wider banking group headquartered in the UK, and any UK bank which is a subsidiary of a wider banking group headquartered overseas.

Retail Ring-Fencing

The most controversial recommendation of the Vickers Commission is that UK banks' retail operations should be "ring-fenced". Banks will be required to establish a separate legal entity within their corporate group structure to provide retail and commercial banking services in the UK.[3] The purposes of this subsidiarisation are, first, to insulate retail banking operations from riskier financial activities and risks inherent in the global financial system and, secondly, in the event of failure, to ensure the continuous provision of retail banking services by ring-fenced banks, with reduced bail-out costs for taxpayers. The key recommendations are that ring-fenced banks:

- alone are to be allowed to obtain permission to provide certain services associated with retail and commercial operations, such as taking deposits from, and providing overdraft facilities to, individuals and small and medium-sized organisations in the UK;[4]
- be permitted to provide limited credit services such as lending to individuals and small and medium-sized organisations, providing trade finance and project finance and advising on and selling products from non-ring-fenced banks which do not give rise to exposures for the ring-fenced bank;
- cannot structure, arrange or execute derivatives transactions (as agent or principal), engage in proprietary trading, originate, trade, lend or make markets in securities, underwrite the sale of debt or equity securities or provide services to non-EEA customers;
- satisfy capital, liquidity and funding requirements on a solo basis;
- only engage in transactions with other entities within the ring-fenced bank's group on a commercial and arm's length basis;
- have aggregate unsecured exposures to other entities within the group of no more than 25% of capital resources after certain deductions (the same limit that currently applies for third parties under the large exposures regime);
- have aggregate secured exposures (gross of the value of the collateral) to other entities in the group of no more than 50% of capital resources after certain deductions and such security should comprise only assets of the highest quality;
- be prohibited from providing unlimited guarantees, indemnities or similar commitments to the rest of the corporate group or from receiving a disproportionate amount of wholesale funding from the rest of the group;
- be subject to stand-alone governance requirements, including a requirement that there be a majority of independent non-executives on the board, with no more than one member from elsewhere within the group;[5] and
- have continuous access to the staff, data and services they require from their group so that the ring-fenced bank can continue to operate irrespective of the financial health of the rest of the group.

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[3] Except for EEA banks that have "passported" into the UK.

[4] The Vickers Commission adopted the same framework for small, medium and large companies as that established in the Companies Act 2006, which currently provides that medium-sized companies are those satisfying two or more of the following: a turnover of not more than £25.9 million; a balance sheet of not more than £12.9 million; and not more than 250 employees. The UK Government Response indicates that further analysis of the definition of SMEs will be undertaken to determine the suitability of the definition in this context.

[5] This requirement would apply unless the vast majority of the group's assets were within the ring-fenced bank.

The UK government has agreed that ring-fencing of retail banking services should be implemented in the UK, though there is still only scant detail on how ring-fencing will be implemented. The UK government also agreed with the Vickers Commission that banks should have relative freedom in respect of their investment and wholesale divisions. Banks will be permitted to continue proprietary trading, for example, in contrast with the position under the proposed Volcker Rule in the US. The rationale, also adopted in the UK Government Response, is that investment and wholesale divisions of UK banks should operate without an implicit government guarantee and be allowed to fail in an orderly manner if they enter into financial difficulties.

Ring-fencing has parallels to the US "swaps push out" requirement,[6] under which derivatives trading businesses are effectively required to be operated from a separate entity to banking activities. Further, under the Volcker Rule, banks are to be prohibited from proprietary trading as well as investing in or sponsoring hedge funds and private equity funds. Whilst the US proposals have separated out or prohibited certain business activities perceived to be highly risky, the ring-fencing proposals in the UK focus on insulating core essential banking services from potential losses caused by other activities. In the UK, the riskier activities will otherwise be left intact within a non-retail investment banking structure. This difference in approach may give rise to issues for banks with a global investment banking model. Such banks may face difficulties in adapting their organisations to conform to both UK and US requirements, as well as co-ordinating business activities and sharing resources between their UK and US operations in the future. The nature and extent of such difficulties will only become apparent once detailed legislative proposals emerge.

Many UK banks will face challenges in implementing ring-fencing requirements, given their current corporate structures. Any restructuring is likely to be a complex and expensive process. The recommendation that intra-group transactions take place on a commercial and arm's length basis may result in burdensome and costly administrative requirements on banking groups. The UK government has accepted the proposal that a ring-fenced bank should not be dependent on the financial health of the rest of its corporate group for its solvency or liquidity, but has stated that it will consult further on the requirements necessary to implement this approach.[7]

Doubts exist as to the effectiveness of some of the recommendations. The large exposure limits recommended by the Vickers Commission are designed to reduce the exposure a UK ring-fenced bank will have to other entities within its group. However, allowing secured exposure within the group of up to 50% of capital may prove ineffective in light of the write-downs of sovereign and asset-backed debts in the financial crisis.

The Vickers Commission dismissed the suggestion that existing UK banking groups might set up headquarters elsewhere in the EEA and passport back into the UK to avoid its ring-fencing and other regulatory requirements. It considered that there would be various legal, reputational and practical impediments to relocation, albeit some smaller banking groups may nevertheless choose to do just this. There may also be an incentive for banks from outside the EEA that wish to operate retail banking in the UK to set up headquarters in another EEA state and passport in, thereby avoiding any UK ring-fencing requirements. EEA passporting rules mean that the ability of the UK government to protect UK retail banking customers from banking crises outside the UK, such as the crisis in Iceland (an EEA state), is constrained. The UK Government Response has not directly addressed this issue. It states that although UK branches of EEA banks will generally be unaffected by ring-fencing provisions, the UK government would expect the prudential supervisor of EEA banks with a branch in the UK to give careful consideration to whether it is appropriate to permit significant amounts of

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[6] Section 716 of the Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (or "Dodd-Frank Act").

[7] UK Government Response, paragraph 2.56.

mandated services to be undertaken in a branch rather than through a UK subsidiary.[8] This will not, however, result in a level playing field for UK ring-fenced banks against their competitors in the EEA.

A further issue relates to pensions in the UK. Under the Pensions Act 1995, if a ring-fenced bank in the UK is a sponsoring employer in a multi-employer scheme and the other sponsoring employers (such as investment banks) in the ring-fenced bank's group become insolvent, the ring-fenced bank is left liable for all the pension liabilities of all the other sponsoring employers. To implement ring-fencing, the Pensions Act 1995 is likely to require amendment in order to insulate ring-fenced banks from responsibility for deficits in group pension schemes. This could also result in a fundamental change in approach for pension scheme trustees. At present, trustees assessing the funding required from sponsoring employers look at the group as a whole, but if some entities within the group were no longer responsible in certain instances for deficits in group-wide schemes, trustees may have to take a more conservative and prudent approach to cater for the risk that some entities would not be liable for shortfalls in the scheme in the event of another entity within the group entering insolvency. Alternatively, the UK government may require UK banks to de-merge their multi-employer pension schemes, but this would be complicated, time-consuming and costly. The UK Government Response contains no sign of how these issues will be addressed.

UK tax law may also be affected. To further insulate UK retail banks, the report recommends that, if those banks are part of a UK VAT group, their joint and several liability for the UK VAT payable by the group that would otherwise arise should be eliminated or mitigated. It is unclear, however, whether such reform would involve the removal of both the burden of UK VAT group registration (joint and several liability) and the benefit (VAT-free intra-group transactions) or of just the burden. The first option, which in effect would involve removing the retail bank from the UK VAT group, would mean higher UK VAT costs for affected banks. As for the second option, it is unclear from a policy point of view why a UK retail bank should reap the benefit of UK VAT group registration without allowing the UK tax authority – and therefore the public as a whole – to continue to enjoy the additional revenue protection that joint and several liability affords. Again, the UK Government Response contains no sign of how these issues will be addressed.

The proposals put forward in the Vickers Report come at a time when there has already been international agreement on higher capital requirements for banks and on a common set of principles for liquidity. It might be questioned whether ring-fencing will turn out to be worth the costs that it will inevitably impose on the banking sector and ultimately on consumers and investors. Once the Vickers Commission was set up, much debate was focused on whether the UK should adopt "narrow" or "utility" banking in which public sector solvency support is only guaranteed for banks providing critical services to the economy (such as deposits and payments) and where such banks are required to invest only in safe assets such as government securities. The Vickers Commission rejected this model in favour of ring-fencing given the impracticality of implementing narrow banking and the inefficiencies it would introduce. However, the Vickers Commission and the UK government have ended up adopting an approach that is untried, untested and of uncertain effect.

Furthermore, ring-fencing may have the perverse outcome of causing regulators to focus overly on risks within the ring-fenced sector whilst missing developments elsewhere in the financial markets that have the potential to cause serious disruption.

Other issues that may arise out of the implementation of retail ring-fencing in UK banks are as follows.

- As many banking products contain elements of both commercial and investment banking packaged together, e.g. loans and credit default swaps, banks will have to revise their existing product structures since elements of those products

[8] UK Government Response, paragraph 2.15.

will need to be offered by two different entities rather than one. This will also lead to increased costs for small businesses, which will have to deal with more than one institutional entity.

- **UK ring-fenced retail banks will be prohibited from contributing to group acquisitions. Structuring acquisitions in the UK in the future will require care to ensure this rule is complied with.**
- **UK ring-fenced retail banks will also be prohibited from lending to "financial companies". The Vickers Commission did not find a suitable definition of "financial companies" in existing legislation and stated that a new one would have to be drafted. This point was not addressed in the UK Government Response. It may be difficult, perhaps impossible, to draft a suitable definition of the term for these purposes. In any case, it will also be difficult to regulate which entity ultimately receives the funds lent by UK ring-fenced banks.**
- **In the Vickers Report, no *de minimis* limit was recommended under which the ring-fencing requirement would not apply. Foreign banks with a small retail banking operation but a larger wholesale and investment operation will be adversely affected by the cost of restructuring. Such banks may be unable to divide their operations in an economically viable way, leading to exits from the UK market. However, the UK Government Response states that the case for *de minimis* exemptions from ring-fencing, in particular for very small firms, should be reviewed.[9] It is therefore possible that a *de minimis* exception could be included in the legislative proposal.**

Improving the "Loss-Absorbency" of UK Banks

The Vickers Commission has separately made various recommendations intended to make UK banks better able to absorb losses, which include:

- **a requirement that the ratio of equity to risk-weighted assets ("RWAs") of large[10] ring-fenced banks in the UK be at least 10% (and up to 13% if the regulator has concerns about its ability to be resolved at minimum risk to the public purse), with a lower ratio for smaller banks;**
- **that all UK-headquartered banks maintain a Tier 1 leverage ratio of at least 3% (4.06% for large ring-fenced banks);**
- **that UK-headquartered global systemically important banks and large UK ring-fenced banks have capital of core equity and bail-in subordinated debt of at least 17% of RWAs, with a lower ratio for smaller UK banks;**
- **that all unsecured debt of banks with a term of at least 12 months be subject to a "primary bail-in power", i.e. be written down in the event the bank is recapitalised, with all other unsecured liabilities, or liabilities secured only by a floating charge, to be subject to a "secondary bail-in power", i.e. to be written down in the event that the primary bail-in power is insufficient; and**
- **a revision of the priority of creditors in an insolvency so that deposits in banks insured by the UK's Financial Services Compensation Scheme are accorded preferential status (above floating charge holders).**

The ratio of equity to RWAs proposed by the Vickers Commission for large UK ring-fenced banks (of 10%) is higher than that proposed in Basel III (generally between 8-9.5% for systemically important banks).[11] The requirement for large UK ring-fenced banks to have primary loss absorbing capacity of 17% is significantly more onerous than under Basel III,

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[9] UK Government Response, paragraph 2.69.

[10] "Large" is defined by the Vickers Commission as ring-fenced banks with a ratio of RWAs to UK GDP of 3% or greater, which is thought to include Barclays, HSBC, Lloyds Banking Group, Nationwide, Royal Bank of Scotland and Santander UK (see Table 4.2, Vickers Report).

[11] The Basel III consultation document is available at http://www.bis.org/publ/bcbs201.pdf.

under which systemically important banks will be required to hold capital at 11.5-13% of RWAs.[12] The UK government provisionally agreed that 17% is the appropriate number for the largest institutions, subject to further consultation.[13] Further, there will need to be an accommodative tax regime for contingent capital instruments or "bail-in" subordinated debt for banks to use these instruments to meet their enhanced capital ratios. HMRC is currently looking at ways to ensure these instruments benefit from debt treatment and therefore tax deductibility of interest payments.

An important concession has been made by the UK government to UK-based globally systemically important banks. The Vickers Commission had proposed that such banks would need to have primary loss absorbing capital equal to at least 17% across all their global operations. However, the UK government has stated that so long as such a bank can show that any non-UK operations do not pose a risk to UK financial stability, the requirement will not apply to those non-UK operations. Such a bank could evidence this through producing a robust, credible plan for the resolution of foreign operations separately from the resolution of its UK operations. This proposal is thought to benefit banks such as HSBC, whose corporate structure consists of separate subsidiaries for its operations in various markets globally.

Concurrent with these proposals, the EU Commission has brought forward proposals to implement the Basel III accord in the form of a new Directive and Regulation (known as CRD IV).[14] The capital requirements in the proposed regulation will, if enacted, be directly applicable in UK law, with minimal flexibility for Member States to impose lower or higher capital requirements. The EU Commission has suggested limited circumstances in which national governments may apply stricter requirements, but only through the counter-cyclical buffer as proposed in Basel III, intended to permit national regulators to impose up to 2.5% additional equity to RWAs to guard against specific risks to financial stability.[15] Without changes to the EU Commission's current proposals, it is questionable whether the UK government will be able to implement the higher capital requirements set out in the Vickers Report.[16] In the UK Government Response, this constraint is acknowledged and it is stated that negotiations with the European Commission, the European Parliament and other Member States are ongoing to allow national governments to impose more stringent minimum requirements.[17] There are further instances of where existing EU legislation is proving a constraint to reform in the financial sector by national governments. For example, the Kay Review of UK Equity Markets, which published its Interim Report in February 2012, has stated that its remit is constrained to relatively narrow issues because many of the changes it would seek would require amendments to existing EU legislation. The breadth of EU competence will, it is suggested, prove to be a significant roadblock to reform at national level in the financial sector.

The proposal to accord insured retail deposits preferential status would constitute the most significant change to the hierarchy of creditors in UK insolvency law since the Enterprise Act 2002. The UK Government Response states that this recommendation is supported "on balance", though further consultation is needed on the scope of the change.[18] Depending on the amount of an institution's insured deposits, this could significantly reduce the recovery of a floating charge holder and unsecured creditor out of an administration or liquidation, with an inevitable impact on the funding

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[12] However, note that bonds with a term remaining of at least 12 months can count towards a bank's primary loss-absorbing capacity, which is less stringent than under Basel III requirements (at least five years).

[13] UK Government Response, paragraph 3.57.

[14] CRD IV consists of a Directive and a Regulation published by the EU Commission on 20 July 2011 to replace the current Capital Requirements Directives (the Banking Consolidation Directive 2006/48/EC and the Capital Adequacy Directive 2006/49/EC).

[15] See the FAQs document concerning the proposals also published on 20 July 2011. The FAQs document, as well as the draft CRD IV Directive and Regulation can be accessed at http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm.

[16] The Vickers Commission appears to accept there may be difficulties in the implementation of its recommendations (Paragraph 5.95, Vickers Report). See "Fight expected over EU bank capital rules", Financial Times, 19 July 2011.

[17] UK Government Response, paragraph 6.6.

[18] UK Government Response, paragraph 3.51.

costs of retail banks. The recommendations in the Vickers Report have led to suggestions that "free banking" in the UK retail banking market is unsustainable as increased capital and funding costs will ultimately have to be passed on to banks' customers.[19] Further, this reform may incentivise lenders to banks to seek additional security, with the consequence that the level of asset encumbrance of UK ring-fenced banks could increase. The Vickers Commission accepts these risks but suggests they can be mitigated by regulator supervision. However, to restrict a bank's ability to use its assets as collateral could inhibit a bank raising finance or lending at a time when the supply of unsecured financing and corporate loans in the financial system has shrunk.

As a comparator, since 1993 the US has provided that deposits have a preferred status following the insolvency of a bank. Unlike the proposals in the Vickers Report, US law gives preference to all deposits, as defined by law, and not only insured deposits. The US proposal was to protect the Federal Deposit Insurance Corporation (the "**FDIC**") and the deposit insurance fund. In the event of a bank liquidation, the FDIC would recoup the expense of payouts for insured deposits ahead of other creditors. However, small banks were concerned that such a limitation would provoke corporate depositors to hold large deposits only at large banks, which were perceived as being generally safer than small banks. Therefore, the compromise was to grant the preference to all deposits.

The term "deposits" has a specific definition in the US, which includes borrowings and other issuances (such as cashier's checks) that are not termed a deposit by the issuing bank. However, it does not include deposits payable only at a non-US branch of the bank. Thus, if a FDIC-insured bank with non-US branches were to be declared insolvent and liquidated, depositors at non-US branches would not be entitled to payment until FDIC expenses were recouped and all holders of deposits, as defined in the statute, are fully paid. Any deposit insurance or other arrangement of the foreign country where the branch is located might provide additional protection.

In practice, despite some concerns that depositor preference would create problems for US banks, such as demands for collateral for non-deposit credit extensions, it appears that FDIC-insured banks have not been faced with such problems to any significant degree. The massive credit disintermediation of 2008-09 appears to have been caused in part by a general concern about bank creditworthiness and not by depositor preference. Whether the changes being wrought by the Dodd-Frank Wall Street Reform and Credit Protection Act will bring about further changes remains to be seen.

Increasing Competition

The Vickers Report also makes recommendations to increase competition in the UK banking sector. The key recommendations are:

- that the UK government negotiate a more substantial and significantly better-funded divestiture of Lloyds Banking Group (known as Project Verde) with a market share of personal current accounts of at least 6%;
- to establish a "current account redirection service" to smooth the process of switching current accounts for individuals and small businesses;
- to make the cost of personal and business current accounts more transparent by introducing a standardised format of pricing to allow consumers to compare current account products (conceptually similar to standardised annual percentage rates);

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[19] See "Vickers report on banks: how the proposals affect you", Financial Times, 12 September 2011.

- to ensure that the primary duties of the future Financial Conduct Authority[20] include the promotion of competition within the UK banking sector (as currently proposed by the UK government);[21] and
- to consider whether to make a market investigation reference in the next few years if the recommendations as implemented do not have sufficient impact (if the Office of Fair Trading or the Competition Commission has not already commenced an investigation by then).

The UK Government Response contains broad support for all the measures above, particularly as regards smoothing the process of switching current accounts and increasing price transparency.

Vickers for Europe?

A "High-level Expert Group on structural aspects of the EU banking sector" is to be established by the European Commission to determine whether, in addition to ongoing regulatory reforms, further structural reforms of EU banks would strengthen financial stability and improve efficiency and consumer protection. The group will discuss the possibility of an EU-wide banking ring-fence – similar to that recommended by the Vickers Commission. This group will also discuss, as an alternative, an EU proposal along the lines of the US Volcker Rule (discussed above), although this would conflict with the "universal banking model" of many continental European banks and institutions.

Commissioner Michel Barnier provided that the group should start work in February this year and finish during the summer, making any proposals at that time.

In Germany, the separation of investment banking activities from retail banking has not been seen as a top priority by Germany's federal government and its bank regulators. So far there have been no specific initiatives to introduce new legislation similar to the Volcker Rule or to the measures proposed in the Vickers Report. However, Germany's finance minister Wolfgang Schäuble has stated that he is "open to discussions on an international level" and that he considered the UK plans an "interesting idea". The leader of the German Social Democrats, Sigmar Gabriel, has strongly promoted the separation of retail and investment banking in recent speeches.[22] That said, there is doubt as to whether any such measures will gain traction, particularly if the proposals for an EU-wide bank insolvency, or at least recovery and resolution, regime for financial institutions are realised.

Next Steps

The UK Government has stated it will publish a White Paper in the Spring of this year, setting out how it will implement the Vickers Commission's recommendations. Following a three month consultation on the White Paper, the Government intends to introduce primary legislation into Parliament with a view to enacting, by May 2015, the measures necessary to implement Vickers' recommendations. Banks will then be expected to comply with the new ring-fencing legislation as soon as practicable. Non-structural changes relating to loss absorbency are to be implemented in stages and fully completed by the beginning of 2019.

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[20] For a description of the proposed Financial Conduct Authority, our client publication "The Proposed Restructuring of the UK Financial Regulatory Framework" is available at http://www.shearman.com/the-proposed-restructuring-of-the-uk-financial-regulatory-framework-09-26-2011/. The White Paper and draft Bill published on 16 June 2011 in the document entitled "A new approach to financial regulation: the blueprint for reform" (Cm 8083) are available at http://www.official-documents.gov.uk/document/cm80/8083/8083.pdf.

[21] *Ibid.*

[22] Cf. Handelsblatt-online, 17 October 2011.

This publication is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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