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The Vickers Report: 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. This memorandum summarises the key recommendations and their likely impact.

Introduction

The Independent Commission on Banking (the "**Vickers Commission**") was set up by the Coalition Government to make recommendations for 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] All three of the UK's main political parties have approved the report's recommendations.

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 to provide retail and commercial banking services in the UK.[2] 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:

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

2 Except for EEA banks that have 'passported' into the UK.

- 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;[3]
- 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;[4] 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.

Absent draft legislation, there is a dearth of detail on these recommendations at present. However, these recommendations leave banks with relative freedom in respect of their investment and wholesale divisions. They will be able to continue proprietary trading, for example, in contrast with the position under the proposed Volcker Rule in the US. The rationale 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,[5] 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 has 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

3 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 £25.9million; a balance sheet of not more than £12.9million; and not more than 250 employees.

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

5 Section 716 of the Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (or 'Dodd-Frank Act').

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 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.

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 securitised 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. The Vickers Commission 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.

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 liable, trustees may have to take a more conservative and prudent approach to cater for the risk that some entities would not be liable in the event of an 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.

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.

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 has 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 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 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. 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.
- No *de minimis* limit has been 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.

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[6] 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

6 '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).

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).[7] The requirement for large UK ring-fenced banks to have primary loss absorbing capacity of 17% is significantly more onerous than under Basel III, under which systemically important banks will be required to hold capital at 11.5-13% of RWAs.[8]

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).[9] 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.[10] 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. [11]

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. 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 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.[12] 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.

Increasing Competition

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

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

8 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).

9 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).

10 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.

11 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.

12 See 'Vickers report on banks: how the proposals affect you', Financial Times, 12 September 2011.

- 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);
- to ensure that the primary duties of the future Financial Conduct Authority include the promotion of competition within the UK banking sector (as currently proposed by the UK government);[13] 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).

Next Steps

The Vickers Commission has recommended that both the ring-fencing and loss-absorbency measures should be implemented by the end of 2019, i.e. on a similar timeline to the implementation of Basel III. The UK government has stated the Vickers Commission's recommendations will be accepted and that a formal response will be given before the end of 2011. Legislation will be enacted in this Parliament (by 2015) to implement the recommendations.

13 See the Shearman & Sterling Memorandum published on 26 September 2011 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) (available at http://www.official-documents.gov.uk/document/cm80/8083/8083.pdf/).

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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