

19 December 2013

Vickers Recommendations on Bank Ring-fencing Made Law in the UK

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

Contacts

Barnabas W.B. Reynolds
London
+44.20.7655.5528
barney.reynolds@shearman.com

Bradley K. Sabel
New York
+1.212.848.8410
bsabel@shearman.com

Thomas Donegan
London
+44.20.7655.5566
thomas.donegan@shearman.com

Donald N. Lamson
Washington, DC
+1.202.508.8130
donald.lamson@shearman.com

Hervé Letrégilly
Paris
+33.1.53.89.71.30
hletreguilly@shearman.com

Azad Ali
London
+44.20.7655.5659
azad.ali@shearman.com

Kolja Stehl
Frankfurt
+49.69.9711.1623
kolja.stehl@shearman.com

James Campbell
London
+44.20.7655.5570
james.campbell@shearman.com

Sandy Collins
London
+44.20.7655.5601
sandy.collins@shearman.com

SHEARMAN.COM

New laws requiring the ring-fencing of retail banking from investment banking have been enacted in the UK. The protection of retail businesses was one of many recommendations made by the Independent Commission on Banking in 2011. The full implications will only be understood once the secondary legislation is made and rules have been published by the UK regulators.

The Financial Services (Banking Reform) Act 2013 (the “Banking Reform Act”), which received Royal Assent on 18 December 2013, implements the recommendations of the Independent Commission on Banking (the “Vickers Report”)¹ and the Parliamentary Commission on Banking Standards. This note focuses on the ring-fencing provisions. It is of note that this legislation and the final Volcker Rule, a similar US measure, have been published almost contemporaneously.²

The UK Government committed to enact secondary legislation necessary to implement the Banking Reform Act by May 2015. It is anticipated that the secondary legislation will contain an exemption for banks whose retail deposit book (defined to include deposits not only from individuals but also from small and medium sized enterprises) does not exceed £25 billion. The implementation of the necessary measures should be effective by 2019. The Banking Reform Act will come into force in early 2014.

¹ You may wish to refer to our client notes on the Vickers Recommendations, available at:

http://www.shearman.com/-/media/Files/NewsInsights/Publications/2011/10/The%20Vickers%20Report%20What%20the%20Recommendations%20Mean_/Files/View%20full%20memo%20The%20Vickers%20Report%20What%20the%20Recom_/FileAttachment/FIA100511TheVickersReport.pdf and http://www.shearman.com/-/media/Files/NewsInsights/Publications/2012/03/The%20Vickers%20Report%20and%20the%20UK%20Governments%20Respon_/Files/View%20full%20memo%20The%20Vickers%20Report%20and%20the%20UK%20Gov_/FileAttachment/TheVickersReportandtheUKGovernmentsResponseFIA03_.pdf.

² You may wish to review our client note on the final Volcker Rule [here](#).

Which Firms Do the Ring-fencing Provisions Apply To?

The ring-fencing provisions apply to deposit-taking entities, i.e. banks, which are incorporated in the UK, irrespective of the location of their deposit-taking. The provisions do not apply to building societies although the Treasury is given power to make regulations that would apply ring-fencing to building societies in the future.

Ring-fencing Provisions

The Banking Reform Act includes a prohibition on ring-fenced banks from conducting the regulated activity of “dealing in investments as principal” in the UK or elsewhere. This prohibition will be subject to certain exceptions which are still to be published in secondary legislation. The exceptions are likely to follow the recommendations of the Vickers Report to include, for example, exemptions for underwriting and payment services. There is also likely to be an exemption for institutions with less than £25 billion in retail deposits. The Vickers Report itself suggested that various other activities would be permitted within a ring-fenced bank, such as commercial lending, some simple derivatives trading, debt-equity swaps, securitization of own assets and certain ancillary activities, subject to appropriate safeguards. However, these aspects of the UK’s bank ring-fencing rules will be left to secondary legislation.

Secondary legislation may also prohibit a ring-fenced bank from entering into certain types of transaction, contracting with certain classes of persons, establishing or maintaining a branch in a specified country or territory and holding shares or voting powers in certain companies.

Exemptions will be considered based on an evaluation of whether a ring-fenced bank is exposed to risks as a result of an activity being allowed. In addition, consideration must be given to whether the activity would jeopardize the ring-fenced bank’s ability to continue providing its core services if it were to fail—in other words, whether the activity would have a negative impact on the resolvability of a financially distressed ring-fenced bank. “Core Services” in this context means those relating to deposit-taking.

The UK regulators have powers to make rules requiring a ring-fenced bank to make arrangements to ensure the effective provision of those essential services that the bank requires in order to accept deposits. The regulators may also make rules for other licensed firms which are part of a ring-fenced bank’s group (“group ring-fencing rules”). Any group ring-fencing rules will include provisions:

- Restricting the ring-fenced bank from entering into contracts with other members of its group except at arm’s length;
- Restricting the payments that the ring-fenced bank may make to other members of the group;
- Requiring the ring-fenced bank to disclose to its regulator information on transactions between itself and other members of the group;
- Requiring some of the ring-fenced bank’s board members to be independent from other members of the group and for the board to include non-executive members;
- Requiring the ring-fenced bank to comply with a remuneration and human resources policy that meets specified requirements; and
- Requiring the ring-fenced bank to put arrangements in place for the identification, monitoring and management of risk.

In addition, in order to ensure full separation, the ring-fenced bank is likely to be required not to be liable for group pension plans.

The UK regulators also have powers to impose restructuring requirements on a ring-fenced bank, any UK-regulated member of the ring-fenced bank's group and any UK corporation which is a member of the group. Such measures include the power to require the disposal of property, the transfer of the ring-fenced bank to another entity and the disposition of shares or other securities.

Review of Ring-fencing Rules

The Prudential Regulation Authority ("PRA") must undertake a review of its rules on ring-fencing within 5 years of when the first ring-fencing rules enter into force. The PRA must provide the Treasury with a report resulting from its review, which will be placed before Parliament. If the Financial Conduct Authority is required to make any ring-fencing rules, it will also need to comply with these review requirements.

Review of Proprietary Trading

Notably, and in contrast to the Volcker Rule, the Banking Reform Act does not prohibit proprietary trading: it merely requires such activities to be carried on outside the retail banking entity. Within 12 months of the prohibition on ring-fenced banks "dealing in investments as principal" coming into force, the PRA will conduct a review of proprietary trading engaged in by all regulated financial institutions (i.e. not only licensed banks but also brokerages and investment firms). The purposes of the review will be (i) to consider whether any more far-reaching restrictions should be imposed on proprietary trading, and (ii) to determine whether the PRA's powers are sufficient to enable it to deal with the risks posed by proprietary trading. The PRA must make a written report of its findings to the Treasury, which will then appoint an independent panel to review the matter further.

European Union Proposals

Commissioner Michel Barnier, in response to the US financial regulatory agencies' finalization of the Volcker Rule, stated that the European Commission would present its proposals on bank structure in early January 2014. The proposals are likely to be based on the recommendations made in 2012 by the High-Level Expert Group, chaired by Erkki Liikanen, as well as the responses to the Commission's consultation in May 2013. The recommendations of the High-Level Expert Group are conceptually similar to the Vickers Recommendations and include the mandatory separation of trading entities from deposit-taking entities within a group and the additional separation of other activities if deemed necessary by the authorities in light of the institution's recovery and resolution plan.

Some EU Member States have already implemented legislation which transposes ring-fencing principles into national law. The French law on the separation and regulation of banking activities dated 26 July 2012 requires the ring-fencing of proprietary trading and other risky activities from traditional deposit-taking and commercial lending activities, provided certain thresholds are exceeded. Under the recently adopted German Banking Separation Bill, banks and banking groups will be required to separate their proprietary trading and certain other heightened risk activities from their deposit-taking business, provided certain thresholds are exceeded.

Comparison with US Volcker Rule

The Volcker Rule is summarized in our separate client notes.³ A table comparing some of its features is set out below.

UK BANKING REFORM ACT	US VOLCKER RULE
Largely aimed at mitigating bail-out costs and risks of failure for "socially useful" banking functions.	Aimed at ensuring banks only serve customers, not their own interests.
No ban on proprietary trading outside of the ring-fence (subject to review – see the section above on Review of Proprietary Trading).	General prohibition on banking organizations from engaging in proprietary trading and limits bank involvement in private funds.
Focus is on separation of retail and investment banking by ring-fencing through use of subsidiaries.	Focus is on removing the culture of investment-bank businesses from commercial banks and affiliates.
Limited extraterritorial effect for non-UK headquartered banks, although this will depend largely on the secondary legislation.	The Rule applies to worldwide operations of US banks and limits non-US bank involvement with US counterparties.
The Banking Reform Act will come into force in early 2014. The UK Government committed to enact secondary legislation necessary to implement the Banking Reform Act by May 2015. Implementation of measures should be effective by 2019.	21 July 2015 is the conformance date. The largest banks will be required to begin to submit various data on market-making activities beginning in July 2014, and the agencies' staffs will review that data prior to the conformance date.

Other Measures included in the Banking Reform Act

The Banking Reform Act also covers measures on creditor bail-in, depositor preference, the regulation of payment systems, increased regulation of directors and senior employees, administration provisions for financial market infrastructure systems (other than central counterparties), powers for the UK regulators to make rules applying to parent undertakings and claims management services. We will consider these issues in future client memoranda.

³ You may like to view our client publications on the Volcker Rule [here](#).