RFPT
RING-FENCING
AND PROPRIETARY
TRADING REVIEW

Ring-fencing and Proprietary Trading
Independent Review

Final Report

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Foreword

Keith Skeoch – Chair of the RFPT Independent Review

Over the last twelve months I've had an opportunity to delve back into an issue that has dominated the work of regulators and the banking sector for the last decade. HM Treasury gave me the unique privilege of leading an independent review into one of the biggest reforms of the banking sector in a generation – the introduction of ring-fencing. Supported by a Panel with deep experience and expertise, my focus has been to deliver an evidence-based report that not only looks at the impact of the regime to date, but is also thoughtful about its role in minimising risks to the public purse associated with a future bank failure.

The Report sets out how ring-fencing did achieve some of what it set out to and has helped to improve the resilience of UK retail banking. It did this by contributing to improvements in the safety of large and complex retail banks and by making them potentially easier to resolve and supervise. The increase in costs of change and compliance were broadly in line with official estimates, and we found no evidence of banks undermining or circumventing the ring-fence, a hint perhaps of the cultural change the Independent Commission on Banking sought to promote. The Bank of England and Prudential Regulation Authority (PRA) also played an important role through their diligent oversight of the regime's implementation and operation.

The relative size of banking in the UK economy has fallen faster than elsewhere and the overall impact of ring-fencing on competition within the mortgage and banking markets appears to be modest so far, relative to the many concerns that were voiced. However, we are mindful that the regime has only been fully operational for a limited period, during which the impacts may have been masked by other structural forces including the Covid-19 pandemic and the UK's exit from the EU, as well as other macroeconomic factors including expansionary monetary policy.

While all three powerful forces play out, we are of the view that the ring-fencing regime is worth retaining at present but recommend several important changes both to the way in which it operates and its interaction with the resolution regime. Ring-fencing has been set up in a way that has created several cliff edges for banks and their customers, in particular SMEs, that cumulatively have resulted in an overly rigid regime. While partly by design, our evidence suggests that this rigidity creates several issues for customers and the flow of services and finance to support them. It also creates complexity that has the potential to constrain the competitiveness of UK banks. If not addressed, it may lead to the ossification of retail banking as banking services continue to innovate and develop.

From the beginning, I stressed the need for this review to be evidence-led. The evidence shows that the ring-fencing regime is worth retaining at present but needs to be more adaptable, simpler and more coherent with wider regulation in order to better serve the needs of customers and ensure it can address the risks of the future as well as those of the present and past. The regime's benefits will diminish with time while the resolution regime overtakes it in providing a more comprehensive solution for tackling too-big-to-fail.

Our main recommendation would change the scope of the regime in the longer term by giving the authorities more flexibility and a new power in their toolkit to remove banks from the ring-fencing regime that are judged to be resolvable. While we acknowledge both the complexity of the task and time it may take to do this, we also believe it is an issue that the authorities should start to address as soon as possible. The Report explores these themes and issues in more detail, but our overall approach aims to build on the strengths of the banking reforms over the last decade while being thoughtful about the future.

A key lesson from the last fifty years is that a sector as dynamic as the banking sector needs a regulatory regime that is equally dynamic, that can respond to new threats, and address new economic challenges and new opportunities, while maintaining financial stability. That is what this report and its package of recommendations aims to deliver, to help to insulate the public purse from the cost of too-big-to-fail.

The proprietary trading review has not received as much limelight, but the Panel has been rigorous in exploring the potential risks around this type of activity in UK banks, building on the thorough assessment that the PRA undertook in 2020. Overall, we did not uncover any issues, but it is important to keep a vigilant eye on the risks arising in this area, not just from the banking sector, but also increasingly from the non-bank sector.

I would like to thank the Panel for their collective wisdom and individual insights; the secretariat for their invaluable analysis, dedication, and support and both for their fellowship and good humour. A good deal of this review had to be carried out under the challenges of lockdown using the modern ether that broadband fortuitously provided.

Executive Summary

Ring-fencing review

Background

Ring-fencing was introduced in the UK following the recommendation of the Independent Commission on Banking (ICB) in 2011, as one component of a package of major reforms to banking regulations in the aftermath of the 2008-09 global financial crisis (GFC). The crisis exposed significant weaknesses in banks' resilience and regulation, which had severe consequences for households, businesses and public finances. The reforms were intended to increase the resilience of core banking services and importantly, to address the concern that some banks were 'too-big-to-fail' and minimise risks to taxpayers.

Most reforms on banking regulation were based on common standards agreed with banking regulators from other jurisdictions. They included substantial increases in the requirements for banks to maintain capital and liquid assets, in addition to a more challenging supervisory approach. A lot of work also went into establishing credible resolution regimes, to ensure that banks have debt liabilities that can be bailed-in and that they can be resolved to maintain critical functions without taxpayer support.

The objective of ring-fencing was to insulate retail banking services, such as deposits and overdrafts, the elements of banking judged at the time to be most critical, from non-retail activities such as investment banking and international banking. In contrast to the other global reforms, the UK is an outlier for having legislated to specifically ring-fence activities, although some jurisdictions also introduced country-specific policies that involved separation or prohibition of retail and non-retail banking activities. This was deemed to be warranted in the UK given the relative size of its banking sector to the economy. However, the proportion of the UK's banking sector in the economy has reduced markedly since 2008.

There have been other important changes to the environment in which UK banks have been operating since the global financial crisis and since the regime came into force in January 2019. These include the UK's recent withdrawal from the European Union; the growth in importance of the non-bank sector in provision of finance and wider financial services over the past decade; ongoing advances in retail banking services driven by technology; and the Covid-19 pandemic and associated financing needs of the UK economy. The Panel has assessed the evidence submitted to it, and makes its recommendations within this evolving context.

Impacts on financial stability

Benefits

The Panel's view is that following the implementation of the overall package of reforms, retail banking in the UK is safer than it was before the global financial crisis, and ring-fencing contributes to this additional safety. It has achieved this through creating distinct retail deposit-taking entities that are well capitalised and liquid; enabling easier supervision of these ring-fenced bodies (RFBs) in large, complex banks; and protecting the retail component of a failing bank in some very narrow scenarios, such as when a failure is caused by a non-ring-fenced body (NRFB), by making it easier for the authorities to carve it out.

Limitations

However, there are a number of areas where the regime has been less successful. In particular, ring-fencing has not increased the resilience of less complex banks within the regime; the benefits of increased resilience, better supervision and better protection have been relevant only for RFBs, not NRFBs and the wider group; and the reduction in the implicit government guarantee and progress in ending too-big-to-fail was not found to be attributable to ring-fencing. The last point is instead attributable to the development of the UK resolution regime.

Critical functions and the importance of NRFBs and the resolution regime

The concept of banking functions that are critical to the economy has evolved since ring-fencing was proposed in 2011. At the time, the services that were considered critical were taking deposits from, and providing overdrafts to, individuals and small and medium-sized enterprises (SMEs).

Critical functions are defined by the Prudential Regulation Authority (PRA) to include investment banking activities, corporate banking activities, lending between financial institutions, as well as other activities. These activities are prohibited from being inside an RFB, resulting in critical functions now being carried out in NRFBs, making NRFBs more important than originally envisaged.

The Bank of England submitted evidence that in the event of a bank failure, an insolvency option would not likely be a credible option for an NRFB that provides critical functions. The financial stability impacts would be material for the UK economy. If a major UK bank fails, the option created by ring-fencing to carve out the RFB while placing the NRFB into insolvency, would not be a viable option.

Following the GFC, the UK resolution regime was developed to provide the Bank of England with a set of legal powers to manage a bank failure in an orderly way that allows it to maintain critical functions, protect public funds, and protect financial stability.

While the ring-fencing regime is silent on the critical functions provided by NRFBs, the resolution regime acknowledges the importance of NRFBs and aims to manage the failure of an NRFB in an orderly way alongside the RFB.

The ring-fencing regime explicitly prioritises the resilience of RFBs over NRFBs. This creates an inconsistency between the regimes, where the resilience of an RFB is prioritised over an NRFB, but in a failure the critical functions of both are recognised as being important.

Without the resolution regime, and with critical functions on both sides of the ring-fence, taxpayers remain financially exposed if forced to rely on the ring-fencing regime to manage the failure of a bank. In other words, the ring-fencing regime does not act as a comprehensive backstop if the resolution regime is unable to manage a bank failure.

The Panel recognises that the critical function of taking deposits is very important for the economy. The resolution regime is designed to ensure the continuation of all critical functions when a bank fails, so the provision of deposit-taking services would be protected.

Based on the financial stability assessments of the Bank of England, the Panel acknowledges that the distance to failure for UK banks is large at present. However, the UK does not operate a zero-failure regime and therefore the risk to public funds needs to be addressed.

The evolving regulatory landscape throughout the past decade has resulted in two regimes that are not aligned in the way they aim to address too-big-to-fail, adding complexity to regulation in the UK. Over time the distance that is developing between the ring-fencing and resolution regimes is likely to grow.

The ring-fencing regime was an earlier attempt at addressing too-big-to-fail with a focus on a narrow set of critical functions. But it is the resolution regime that is now overtaking ring-fencing in providing a more comprehensive solution for tackling this issue.

Other financial stability risks

Aside from the financial stability impacts in relation to the objectives of the regime, there are some increased risks to financial stability as a result of ring-fencing. First, evidence suggests that NRFBs have lower resilience to severe liquidity stresses than RFBs. They are more prone to liquidity outflows and do not have large amounts of eligible collateral that is considered to be of high enough quality to pre-position with the Bank of England to access its liquidity insurance facilities in times of stress. Ring-fencing has also resulted in RFBs whose credit risks are more concentrated in the UK mortgage market than is the case for the group as a whole.

Impacts on competition and competitiveness

Isolating the impact of the ring-fencing regime on competition and competitiveness is challenging because there have been other significant drivers for the banking sector since the regime was brought into legislation in 2013 and since it came into effect in January 2019. These include expansionary monetary policy and banks' strategic business decisions over the last decade, and more recently the Covid-19 pandemic. Nevertheless, the focus of this Review was to identify whether impacts could be attributed to the regime.

Funding and liquidity in the UK banking sector

Ring-fencing, by design, has resulted in a concentration of deposit funding inside the ring-fence. Stakeholders suggested that liquidity in RFBs is underutilised. Since the start of the Covid-19 pandemic, liquidity has increased substantially for banks globally, including RFBs in the UK whose retail deposits grew by £186 billion in the year to December 2020. Excess liquidity above internal liquidity targets held by the five largest RFBs was £120 billion as of September 2021, triple the pre-Covid-19 levels of £40 billion. This increase has been due to a range of factors during the Covid-19 pandemic, including further monetary policy stimulus and bank funding support from central banks. At the same time deposits grew as a result of households spending less and saving more. However, evidence shows banks and building societies outside of the ring-fencing regime also have excess liquidity.

It is challenging to be certain whether the recent increase in liquidity is temporary or more sticky. Depending on customer decisions, central bank monetary policy and other funding and liquidity schemes, as well as individual bank strategies and risk appetites, the constraints imposed by ring-fencing may result in this liquidity being deployed in the retail banking markets.

Competition in the UK retail banking market

Large UK banks have a competitive advantage over smaller banks, which pre-dates the ring-fencing regime. RFBs' market share in most of the retail loan markets has generally been flat. Gross lending has been increasing for both RFBs and competitor firms by 27% and 43% respectively since 2015.

Whilst RFBs' market share in deposit taking has remained high, it had been falling in the period to 2019. This decline has slowed in the subsequent two years, which likely reflects the influx of deposits as a result of the Covid-19 pandemic. While monetary policy is a key factor driving interest rates lower, relative interest rates paid by RFBs compared to the competitors post 2019 have not seen a discernible decrease.

Ring-fencing does not appear to have caused a change in the market share of RFBs across retail markets. It is unclear what will happen to the Covid-19 induced liquidity, but if it is deployed in retail banking markets, it will likely increase competition for borrowers and drive down prices.

During consultations challenger banks did not state that ring-fencing was a significant constraint on their businesses, rather they cited other factors such as holding relatively more lending capital than larger banks;

and RFBs having a lower cost base that comes with scale. Most challenger banks remain well below the regime's £25 billion deposit threshold.

Competition in the UK mortgage market

Indicators of market concentration suggest that the mortgage market is not excessively concentrated nor has concentration increased following the introduction of the ring-fencing regime. Analysis shows that the unadjusted mortgage market share for RFBs was stable between 69.1% and 69.0% in the three years to mid-2020. Since 2019 the market share of RFBs for gross residential mortgages has reduced in terms of the number of mortgages but it has increased in terms of value. This indicates that RFBs have increased their stock of higher-value mortgages relative to their competitors. The market share for building societies has continued to remain at or above the 21.5% it was in 2016.

The UK mortgage market has had a long-term trend of tightening spreads well in advance of ring-fencing legislation and implementation. Some research has concluded that the ring-fencing regime caused about 10% of the overall decline in mortgage spreads from 2013 to 2019, but that ring-fencing was not the major driver. During the Review's consultations, HSBC noted that post-2015 it reviewed its mortgage strategy and increased mortgage availability through brokers, but that this was not related to ring-fencing. Balancing the mixed results of the quantitative and qualitative analysis, the Panel concluded that ring-fencing has had at most, a minor impact on mortgage spreads but has not impacted the approach of banks inside the regime. Overall, other factors have been driving competition in the mortgage market. However, it is possible that impacts could materialise in the future, in particular in response to existing excess liquidity.

Corporate lending and productive finance

The evidence shows some marginal impacts on the provision of wholesale finance from banks in the regime, but overall there was no material impact in terms of credit supply or pricing for UK corporate and SME lending markets.

Bank lending remained broadly flat in the run-up to the implementation of the ring-fencing regime and for the first 12 months after. Banks in the regime saw a small fall in market share of overall corporate lending following the implementation of the regime but this has been reversed and RFBs' loan stock is now at its highest point in seven years.

Competitiveness of UK banks

As expected by the design of the regime, NRFBs needed to raise more wholesale funding, which is more expensive and raised their funding costs. However, wider macroeconomic conditions appear to have minimised the impacts so far.

UK banks' investment banking revenue growth has remained fairly constant since 2014. However, the impact analysis was limited and sensitive to idiosyncratic factors as only two of the UK banks within the ring-fencing regime have material global investment banking activities that they are committed to maintaining or expanding.

There is regulatory arbitrage as a result of international investment banks being allowed to use up to £25 billion of deposits to fund investment banking activity. However, the amounts utilised in this way are currently immaterial.

The Panel's view is that, while ring-fencing may over time have an adverse effect on the growth and competitiveness prospects of NRFBs, there is limited evidence of this having occurred to date.

Operation of the ring-fencing regime

There is no evidence of banks undermining the objectives of the ring-fence or "tunnelling under" it. Anecdotal evidence suggests that banks have taken a cautious approach when implementing the regime.

RFBs are prohibited from carrying out certain activities, which in turn means that they cannot sell some types of financial products to their customers. To avoid breaking the rules and to reduce compliance and reporting costs, banks have taken commercial decisions to not provide some banking services to customers even where they are not prohibited from doing so. This has impacted small business customers that straddle the banking services that are offered by RFBs and NRFBs.

Exposure to Relevant financial institutions

The constraints related to RFIs were the most cited issue by respondents to the Review's Call for Evidence. The financial institutions that were intended to be captured by the prohibition were those which engage in financial intermediation and those which may be highly leveraged, have a high degree of maturity or liquidity mismatch, or have a high degree of financial interconnectedness.

The list of customers captured by the RFI definition includes firms, such as high street independent financial advisors and mortgage brokers, that would not be considered high risk and were not intended to be captured. NRFBs are not generally suited to provide services to small RFIs as the product offerings are suited to larger businesses. In one case study, an SME submitted testimony of being de-banked, left without access to a basic savings account because it was classified as an RFI.

Excluded activities for RFBs

Stakeholders submitted that the restrictions on excluded activities are inflexible and potentially give rise to unintended consequences. Excluded activities include dealing in investments as principal and commodities trading. Some submissions outlined that several legal provisions are complex and difficult to apply in practice. Restrictions on merger and acquisition activity, restrictions on servicing central banks, the status of trustees, and the onboarding notifications for customers have been problematic for banks and customers.

RFBs' geographical restrictions

RFBs are not allowed to open a branch or subsidiary outside the UK or European Economic Area (EEA). Similar to the absolute restrictions on some excluded activities and prohibitions, the current geographical restrictions in legislation have limited RFBs' ability to serve their UK customers outside the EEA.

Furthermore, the non-EEA geographic prohibition in legislation is redundant. If a UK bank wished to establish a branch or subsidiary in a third country, it would need to notify the PRA in advance. The bank would also require authorisation in the third country, and the local regulators responsible would likely liaise with the PRA.

Governance of banking groups in the regime

Stakeholders provided submissions that the ring-fencing regime's governance requirements are overly complex and go beyond what is necessary to support the independence of RFBs. Overall, the Panel concluded that the ring-fencing regime's governance requirements reflect best practice of regimes in place elsewhere. Furthermore, the PRA has sufficient flexibility to modify the rules for individual banks on a case-by-case basis and has actively granted such waivers.

The costs of the ring-fencing regime

It was acknowledged at the outset that the regime would impose direct costs on the banks in setting up new structures and operating within the regime. Based on banks' submissions, implementing the ring-fencing regime had a one-off cost for the industry of c. £2.9 billion, which has already been incurred, and has an annual aggregate ongoing cost of £1.5 billion. HM Treasury had previously estimated that the costs would be between £0.5 – 3.0 billion and £1.8 - 3.9 billion respectively.

Ring-fencing review conclusions

On balance, the Panel judges that ring-fencing is worth retaining at present. This is given a number of considerations: the regime's contributions to financial stability – though the benefits will diminish over time; its relatively small economic impacts so far – though these may increase over time; the enormous cost of banking crises and the constrained post-Covid fiscal position; and the fact that the resolution regime is not fully embedded and banks are not yet considered resolvable – which is being progressed.

The Panel recognises that the regime's benefit will likely diminish with time, especially as the resolution regime – designed to ensure the continuation of all critical functions across both sides of the ring-fence in a banking group – is embedded. This is because, as UK authorities become comfortable with the viability of the large banking groups' restructuring capabilities and resolution plans, they should be increasingly confident of their ability to ensure continuity of retail services by exercising their other powers, and without the need for the structural separation imposed by the ring-fencing legislation.

It is plausible that more significant negative impacts of ring-fencing could materialise over time as economic conditions change, or as technological advances continue to evolve practices in retail banking, potentially making it challenging for structurally separated banking groups in the UK to adapt.

In the longer term, there is a risk that retail banking in the UK ossifies and remains focused on addressing the risks and opportunities of the past, rather than being able to adapt to address the risks and opportunities identified in the future. The Panel sees value in prioritising the more dynamic approach of the resolution regime in reducing risks to public funds, as it will continue to play a more prominent role than the ring-fencing regime. This forms the basis of the Panel's recommendations.

Proprietary trading review

'Classic' proprietary trading is a type of activity where a firm uses its own money to trade in financial instruments, speculating on future prices to make a profit. It is usually done on a short-term basis. Following the GFC, some commentators viewed 'classic' proprietary trading activity by banks as being the cause of the crisis and often referred to it as "casino banking". Parliament took the view at the time that there should be strong restrictions on proprietary trading within RFBs, but that there was insufficient evidence to justify imposing a complete ban on this activity for all banks.

Other jurisdictions followed different paths in mitigating proprietary trading risks, with varying degrees of prohibition. France, Germany, Belgium, and the US have all aimed to separate different forms of proprietary trading from the core operations of their banks.

The Panel is satisfied that classic proprietary trading is not undertaken to any significant extent by banks operating in the UK. This has been attributed to increased regulation such as capital and liquidity requirements, reduced risk appetite and incentives following the introduction of the Senior Managers & Certification Regime, and changing remuneration policies. The introduction of restrictions on proprietary trading activity in other jurisdictions, most notably in the US, have also contributed to the change in banks' risk appetite.

Other types of proprietary trading such as hedging activities, market making, liquidity management, and client facilitation continue. The Panel concluded that the risks of proprietary trading activities in the UK banking sector have been and continue to remain appropriately mitigated, and the PRA's powers are currently sufficient to manage any associated risks.

Proprietary trading in non-banks

'Classic' proprietary trading activities are undertaken in the non-bank sector, primarily by principal trading firms and hedge funds. UK banks constitute only a small proportion of the total volume of principal trading activity, currently estimated at 10%. Furthermore, of the top twenty firms that account for almost 90% of principal trading activity in the UK, seven are non-banks. The proportion of trading activity in the non-bank sector is therefore significant.

While direct risks to banks have been reduced, indirect risk exposure from prime brokerage lending to the non-bank sector can contribute to systemic risks and therefore should continue to be monitored. Risk monitoring and management of non-bank financial institutions sits across the financial authorities, largely under the regulatory perimeter of the FCA, and to the extent they create systemic risk, the FPC.

Recommendations

The Panel's recommendations address the key findings outlined in the Report. For the ring-fencing regime, the recommendations focus on the immediate issues faced by customers, banks, and regulators, as well as options to address the ring-fencing regime's primary purpose of tackling too-big-to-fail, and consequently its alignment with the resolution regime. For proprietary trading, the recommendations reiterate the need to continue monitoring related risks in banks, as well as the potential risks from activities undertaken in the non-bank sector.

The most significant changes that the Panel is recommending are in relation to the scope of the ring-fencing regime, which should be recalibrated to capture only firms where there is a clear financial stability benefit. In particular, the Panel recommends the introduction of a new exemption for banks that do not undertake excluded activities above a certain level and, in future, a new power for the authorities to remove banks from the ring-fencing regime where they are judged as being resolvable. The Panel considers it imperative that the practicalities of this latter power should be reviewed by HM Treasury as soon as practicable to ensure risks to too-big-to-fail are addressed.

These two recommendations stem from the Panel's findings that the financial stability benefits of the ring-fencing regime are relevant only when the regime is applied to large, complex banks, that banking services that are critical to the UK economy are undertaken by non-ring-fenced bodies, and furthermore that the resolution regime is now overtaking the ring-fencing regime in tackling too-big-to-fail.

The Panel's other recommendations focus on the customers that banks are able to serve, and the services that banks are permitted to provide them with.

Overall, the recommendations are designed to achieve the following:

a) Improve the outcomes for customers;
b) Maintain financial stability benefits and minimise risks to public funds; and
c) Reduce the rigidity and unintended consequences of the ring-fencing regime.

Recommendations at a glance

Ring-fencing recommendations
1. Change the scope of the ring-fencing regime to focus on large, complex banks a) Banks with deposits below £25 billion should continue to be exempt from the ring-fencing regime; b) Banks with deposits above £25 billion that do not undertake excluded activities above a certain level should be exempt from the ring-fencing regime; c) Only excluded activities above that level should be required to be placed in an NRFB.
2. Align the ring-fencing regime with the resolution regime a) HM Treasury should review the practicalities of how to align the ring-fencing and resolution regimes, with a view to introducing a new power for the authorities to remove banks from the ring-fencing regime that are judged to be resolvable.
3. Adjust the restrictions on servicing relevant financial institutions (RFIs) a) An exemption should be introduced to allow RFBs to provide banking services to smaller RFIs; b) The definition of RFIs should be moved from legislation to the PRA Rulebook; and c) A grace period should be introduced for NRFBs to move customers that are no longer classified as an RFI to an RFB.
4. Improve the operation of the ring-fencing regime through technical amendments a) Transitional periods for complying with ring-fencing rules should be introduced for mergers and acquisitions of banks; b) NRFBs should be enabled to service central banks outside of the UK; c) The status of trustees and insolvency practitioners should be clarified; and d) The notice of declaration onboarding requirement for NRFB customers should be removed.
5. Remove the blanket geographical restrictions from legislation that prevent RFBs from establishing operations or servicing customers outside of the EEA
6. Review the excluded activities under the ring-fencing regime
7. The Bank of England should ensure that sufficient plans are in place as part of its contingency planning to provide liquidity to NRFBs in a stress scenario
Proprietary trading recommendations
8. Monitor risks from proprietary trading activities undertaken by banks in the UK
9. Monitor and mitigate potential risks emanating from proprietary trading activities undertaken in the non-bank sector

Benefits of the recommendations package

Outcomes for customers

The impact on customers, mainly business customers of a medium size, that straddle the boundary of the ring-fencing regime was a recurring issue identified by the Panel. They are large enough to require some of the more complex banking services that an NRFB can offer, but often too small to meet the size criteria set by NRFBs for commercial reasons.

The recommendations to change the restrictions for RFIs, remove geographical restrictions from legislation, and allow a small level of excluded activity in an RFB, are all designed with the customer in mind. These are modest changes that should enable banks to provide SME customers with the banking services that they need.

The new exemption for retail banks that only undertake a small amount of excluded activities will also provide challenger banks and new entrants the ability to grow and scale up without being subject to ring-fencing requirements. This removes a potential barrier to growth which should increase competition in retail banking.

Remaining risks to public funds

It is possible that the resolution regime is not able to fully deal with the failure of a bank, or a wider systemic issue. In such a scenario, it is important for HM Treasury to recognise that the ring-fencing regime will not act as a comprehensive fall-back option. It is possible that public funds are still needed to ensure critical banking services continue and to potentially shore up wider systemic impacts on the UK economy. Having a clear understanding of these financial risks to the taxpayer should enable HM Treasury to act accordingly in advance.

Adapting to future opportunities and risks

The UK financial sector continues to evolve and innovate in response to changing customer needs, technological developments, and a competitive landscape. The recent Covid-19 pandemic has demonstrated that economic and customer needs can change overnight, and public interventions need to be agile. The UK banking sector sits at the heart of the UK economy and needs to be able to adapt to changing circumstances and needs.

The recommendations are intended to provide the authorities and banks with the ability and flexibility to respond to changing circumstances over the short and long term, without the need for frequent legislative programmes. The authorities are best placed to assess the risks to banks, and the proposed changes should enable the authorities to make forward-looking, judgment-based decisions.

The recommendations on removing geographical restrictions from legislation, moving definitions from legislation to regulators, and reviewing the excluded activities will enable authorities and banks to better respond to changing circumstances.

Addressing the interactions between the ring-fencing regime and resolution regime in the future should also provide for a simpler, more coherent regulatory regime for UK banks, as well as banks from other jurisdictions, to operate in.

Chapter 1

Introduction

1.1 The independent Ring-fencing and Proprietary Trading (RFPT) Review (the Review) was set up by HM Treasury to examine the operation of the ring-fencing regime for banks, and separately proprietary trading activities undertaken by banks. Both statutory reviews were required by Parliament under the Financial Services (Banking Reform) Act 2013 (FSBRA). HM Treasury appointed Keith Skeoch (Chair), Betsy Nelson, John Flint, Linda Yueh, Patrick Honohan and Preben Prebensen to the independent review panel (the Panel).[1]

1.2 In line with the Terms of Reference set out by HM Treasury, this report (the Report) provides an assessment of whether ring-fencing has achieved its intended purpose of supporting financial stability and minimising risks to public funds, as well as the regime's impacts on competition in the banking sector and mortgage market, the international competitiveness of the UK banking sector, and the provision of finance to the economy. It also provides an assessment of whether risks related to proprietary trading are appropriately mitigated and the consequences of its evolution.[2]

The Panel's approach to the Review

1.3 On convening, the Panel decided to combine the two separate statutory reviews that were required for ring-fencing and proprietary trading into a single process and final report, given the inherent link between the two.

1.4 The Panel met twice monthly since it was established, which consisted of monthly decision-making meetings to progress the Review and monthly open forum meetings to discuss in depth topics related to ring-fencing and proprietary trading. Summaries of the Panel meetings were published on the RFPT website to ensure transparency throughout the Review.[3]

1.5 The Panel took into account the relatively short period that the ring-fencing regime has been in place since its implementation in January 2019. Since then, there have also been impacts from the Covid-19 pandemic and the UK's departure from the EU. Notwithstanding these changes, the Panel took a comprehensive approach to gathering and assessing evidence. The evidence includes a broad range of qualitative and quantitative sources from firms, regulators, wider literature, and consultations with a diverse set of stakeholders. The evidence gathering stages of the Review are set out in Figure 1.1.

1.6 On 20 April 2021, the Panel launched a Call for Evidence to seek views and evidence from interested stakeholders on the impacts of ring-fencing and proprietary trading. Submissions from stakeholders came from banks, building societies, industry bodies, and those representing customer interests, providing a rich source of material for the Panel to analyse and consider. A fuller summary of the Call for Evidence submissions is available on the RFPT website.[4]

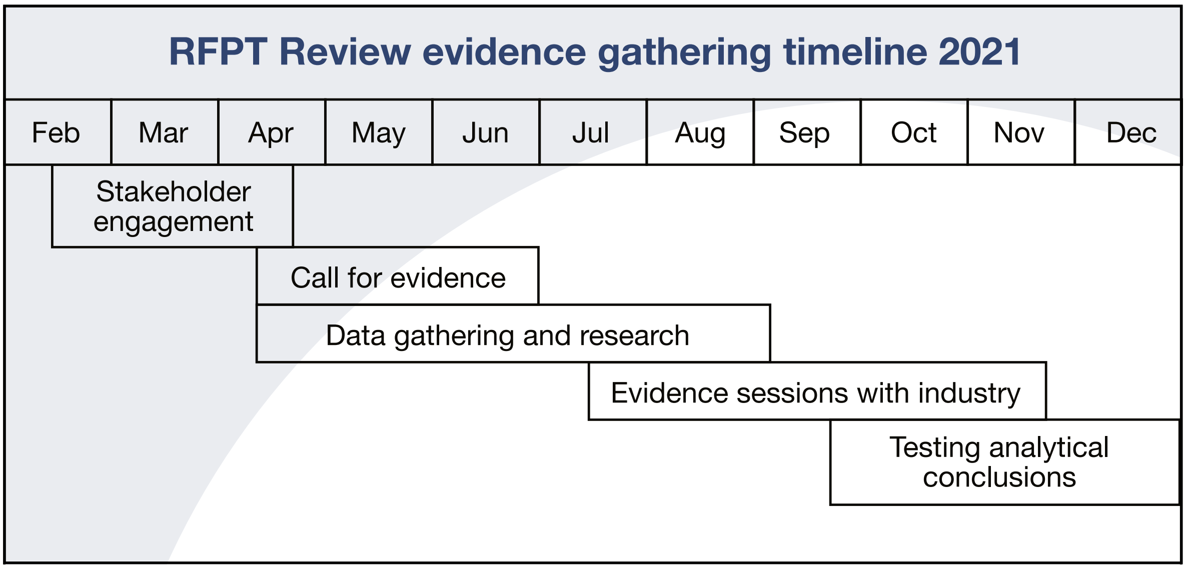
1.7 Separately, the Panel requested information and analysis from the UK authorities, including the Bank of England, the Prudential Regulation Authority (PRA), and the Financial Conduct Authority (FCA), as well as banks in the ring-fencing regime. The Panel further consulted authorities, think tanks, and academics in other jurisdictions, including the USA, Europe, and Asia.

1. *John Flint stepped down from the Panel in September 2021 ahead of his taking up the role of Chief Executive of the UK Infrastructure Bank.*
2. *HM Treasury, 2021, Independent Reviews of Ring-Fencing and Proprietary Trading: Terms of Reference. Available at https://gov.uk/government/publications/members-of-the-ring-fencing-and-proprietary-trading-independent-review-panel-announced-and-terms-of-reference-for-the-review-published/independent-reviews-of-ring-fencing-and-proprietary-trading-terms-of-reference.*
3. *Available at https://rfpt.independent-review.uk/news.*
4. *Available at https://rfpt.independent-review.uk/news/summary-of-call-for-evidence-responses.*

1.8 Given the regulatory nature of the Review, a large amount of information provided by regulators is protected under section 348 of the Financial Services and Markets Act (FSMA) 2000. Similarly, some of the financial data and analysis provided by banks and other organisations cannot be disclosed in the Report for reasons of commercial sensitivity. The Panel also received legal advice throughout the Review.[5]

1.9 **The Panel's extensive programme of stakeholder engagement throughout the Review was both to understand the wide range of perspectives amongst stakeholders and to challenge and test the evidence that was gathered.** This included over 100 meetings with regulators, industry, customer groups, government, parliamentarians, academics, and others. The Panel also held evidence sessions with industry to explore in detail the responses submitted as part of the Call for Evidence.

Figure 1.1: Evidence gathering stages of the Review in 2021



1.10 Collectively, the quantitative and qualitative evidence gathered during the Review enabled the Panel to form a strong basis for assessing the impacts of ring-fencing and proprietary trading, and to develop the conclusions and recommendations for the Report.

Outline of the Report

1.11 The Report is divided into three parts. Part I covers the impacts of ring-fencing. Part II covers proprietary trading activity in the UK following the PRA's review in September 2020.[6] Part III outlines the recommendations of the Panel.

PART I: RING-FENCING REVIEW

- Chapter 2 provides relevant background on the ring-fencing regime.

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5. *From Hogan Lovells.*
6. *PRA, September 2020, Proprietary Trading Review. Available at https://www.bankofengland.co.uk/prudential-regulation/publication/2020/proprietary-trading-review.*

- Chapter 3 sets out the impacts of the ring-fencing regime on financial stability, including whether it has achieved its original objectives, and an assessment of the wider regulatory interactions. It also considers some new financial stability risks.
- Chapter 4 details the wider impacts of the regime on the retail banking sector including the UK mortgage market, the impacts on the international competitiveness of UK banks, and the provision of financial services to the UK economy.
- Chapter 5 outlines the operation of the regime and all its rules, including an assessment of the impacts and unintended consequences as well as the effectiveness of governance structures for banking groups within the ring-fencing regime.

PART II: PROPRIETARY TRADING REVIEW

- Chapter 6 sets out the findings on the extent to which proprietary trading is engaged in by UK banks, including an overview of the types of proprietary trading activities, international comparisons, cultural changes, and activities in the non-bank sector.

PART III: PACKAGE OF RECOMMENDATIONS

- Chapter 7 contains a detailed set of recommendations to address the issues identified for ring-fencing and proprietary trading. The chapter further sets out the benefits of the recommendations.

Part I:
RING-FENCING REVIEW

Chapter 2

Background on ring-fencing

Background

2.1 In the aftermath of the global financial crisis (GFC) of 2008-09, HM Treasury set up the Independent Commission on Banking (ICB) in June 2010 to consider structural and wider reforms to the UK banking sector to promote financial stability and competition. One of the key components of the package of reforms recommended by the ICB in September 2011 was ring-fencing.

2.2 **Ring-fencing requires UK banks to separate their retail banking services, such as deposit taking and overdrafts, from all the other services that banks provide such as investment banking and international banking.** The ring-fencing regime was passed into legislation in FSBRA 2013 and following several years of restructuring by banks in preparation for it, came into effect on 1 January 2019. The ring-fencing regime in its entirety is set in primary legislation, secondary legislation, and the PRA Rulebook and is therefore a combination of legislative and regulatory provisions, as outlined in Annex B, Section 1.

Objectives of ring-fencing

2.3 The ICB stated that its ring-fencing objectives were to:

- *"make it easier to sort out both ring-fenced banks and non-ring-fenced banks which get into trouble, without the provision of taxpayer-funded solvency support;*
- *insulate vital banking services on which households and SMEs depend on from problems elsewhere in the financial system; and*
- *curtail government guarantees, reducing the risk to the public finances and making it less likely that banks will run excessive risks in the first place."*

2.4 The ICB went on to say that *"A ring-fence of this kind would […] be more straightforward than some existing banking structures and thus easier to manage, monitor and regulate. Further, macro-prudential regulation could be more precisely targeted on ring- fenced banks than on existing banking structures."*[1]

2.5 In its response to the ICB's proposals, HM Treasury set out that the aims of ring- fencing were to:

- *"Insulate critical banking services from shocks elsewhere in the financial system; and*
- *Make it easier to preserve the continuity of those services, while resolving financial institutions in an orderly manner and without injecting taxpayer funds."*

2.6 HM Treasury also outlined that the structural reforms would "*substantially reduce the perceived implicit guarantee that derives from the presumption that the government will be compelled to step in to support failing banks*."[2]

2.7 To achieve the aim of insulating critical banking services from shocks and make it easier to preserve the continuity of those services, HM Treasury proposed that only ring-fenced banks would carry out critical banking services in separate entities with individual capital and liquidity requirements.

1. *ICB, September 2011, Final Report. Available at http://bankingcommission.independent.gov.uk.*
2. *HM Treasury, June 2012, Banking reform: delivering stability and supporting a sustainable economy. Available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/32556/whitepaper_banking_reform_140512.pdf.*

2.8 HM Treasury further proposed that ring-fenced banks would be legally and operationally independent with strong independent governance arrangements. At the time, the services that were judged to be critical to the UK's economy were retail deposits and overdrafts for households and small and medium-sized enterprises (SMEs).

How UK banks implemented the ring-fencing regime

2.9 **The ring-fencing regime requires UK banks with more than £25 billion "core deposits" to legally separate their retail banking services.**[3] Smaller banks with less than £25 billion core deposits are exempt. As a result, a total of seven banking groups are subject to the ring-fencing regime: Barclays, HSBC, Lloyds Banking Group, NatWest Group, Santander UK, TSB Bank and Virgin Money.[4]

2.10 Under the regime, banks are required to have separate legal entities to carry out different types of activities. For example, retail activities such as deposit taking must sit inside the ring-fence in a ring-fenced body (RFB), while activities such as investment banking, including securities services for customers, must sit outside the ring-fence in a non-ring-fenced body (NRFB). There are several activities such as lending to corporates, that can sit on either side of the ring-fence, as detailed in Figure 2.1.

Figure 2.1: Division of activities within banking groups

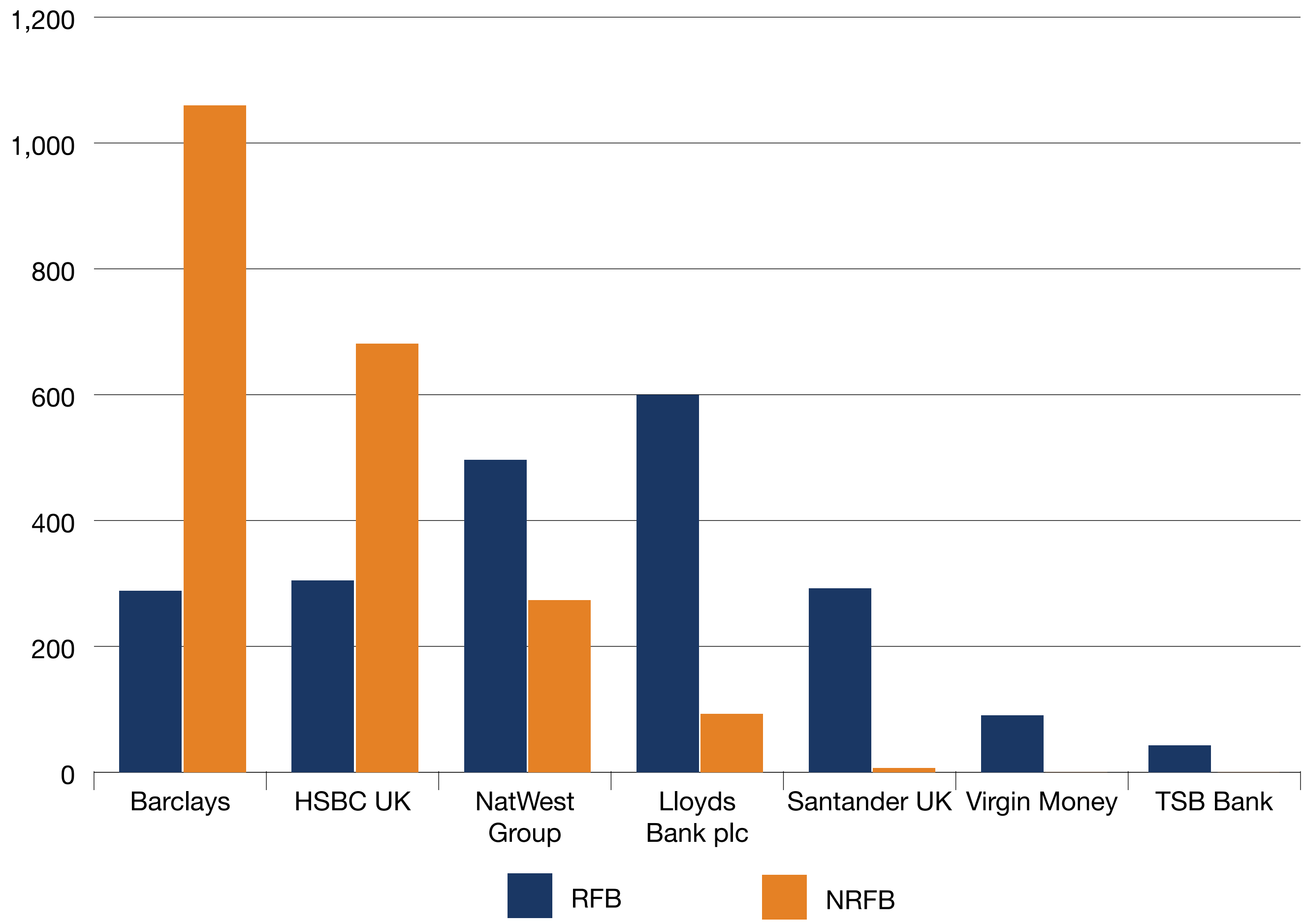
Ring-fenced body	Non-ring-fenced body
Retail and small business deposit-taking	Dealing in investments as principal Commodities trading Having exposure to financial institutions Operations outside of the EEA

Activities open to both entities	
Deposit taking for large corporates, building societies, and other RFBs Having exposure to building societies and other RFBs Lending to individuals and corporates Holding own securitisations Trade finance Payment services	Hedging liquidity, interest rates, currency, commodity, and credit risks for itself Selling very simple derivatives to corporates, building societies, and other RFBs.

3. *Core deposits are determined on a quarterly basis and averaged over a three-year period.*
4. *At the time the £25 billion deposit threshold was decided in 2012/13, TSB Bank and Virgin Money did not exist in their current form.*

2.11 **Banks have taken different approaches to implementing the ring-fencing requirements based on their individual business models and strategies, as illustrated in Figure 2.2.** Some banks opted for a relatively large RFB and smaller NRFB, meaning that they decided to place more of their optional activities in their RFB. Other banks opted for a smaller RFB and a relatively larger NRFB, meaning that they decided to place more of their optional activities in their NRFB.

Figure 2.2: Total assets of UK banks at end-2020 (£bn)



Source: Data from Fitch Solutions

2.12 The difference in approach between banks is clear. Barclays created a small RFB and a larger NRFB to accommodate its international and investment banking activities. HSBC took a similar approach and created a large NRFB.

2.13 In contrast, NatWest created a relatively large RFB as its focus in the UK is largely retail and commercial banking. Lloyds Banking Group similarly created a large RFB to accommodate its retail-focused strategy in the UK. Santander UK moved most of its corporate and investment banking activities to a UK branch of its parent company Banco Santander, placing its retail activities in its RFB.

2.14 Both TSB and Virgin Money are almost solely retail-focused banks, only undertaking a minimal number of activities that are required to be provided in separate NRFBs. They placed almost all of their activities in their RFBs.

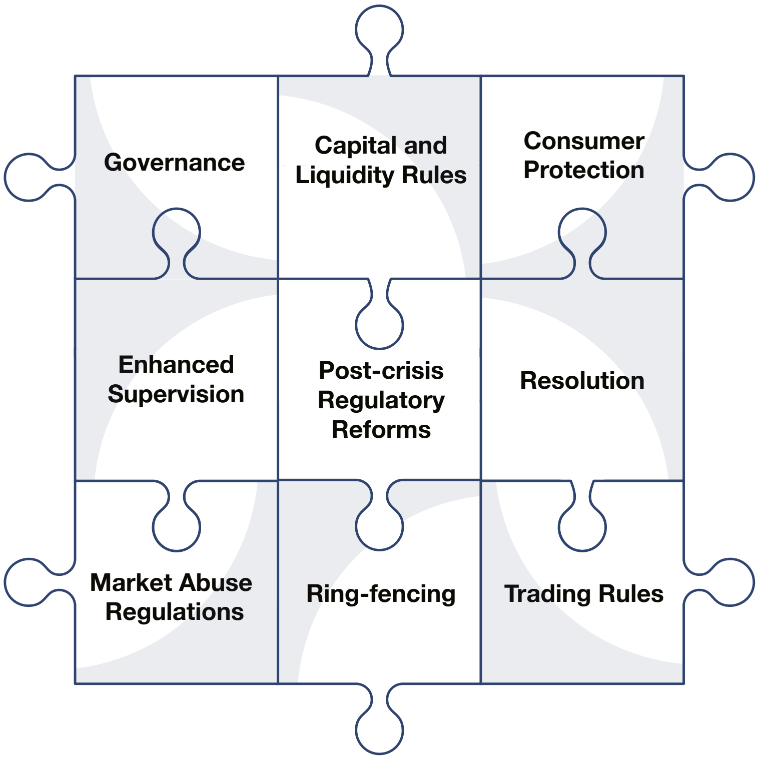
2.15 These variations based on type, size, and complexity of banks have been taken into account in formulating the Panel's recommendations, as outlined later in the Report.

Ring-fencing and the changing UK regulatory landscape

2.16 During the GFC of 2008-09, the UK authorities did not have sufficient tools or powers to resolve large systemic UK banks in an orderly way and so had limited options for managing their failure. The issues that the ICB sought to remedy in 2011, concerning weaknesses in the resilience and regulation of banks and their corporate cultures, were relevant to the needs of the financial system and economy in the period following the crisis.

2.17 The landscape of both the financial sector and the economy has changed in the intervening decade, and regulation has evolved as it has needed to adapt to the changing nature of risk. The various reforms to the banking sector born out of the crisis are outlined in Figure 2.3.

Figure 2.3: Post-crisis regulatory reforms



2.18 With the establishment of the PRA, the FCA, and the Financial Policy Committee (FPC) of the Bank of England, risks are monitored at both the micro and macro levels respectively, with new tools developed to gauge more accurately the risks in the system.

2.19 Rules are now in force to make senior management in banks more accountable through the Senior Managers and Certification Regime (SM&CR), while remuneration rules better align incentives with prudential objectives to discourage excessive risk-taking. The introduction of stress testing exercises undertaken by the Bank of England at both bank and system-wide level help assess whether banks are resilient, with enough capital to withstand extreme shocks while continuing to support the economy.

2.20 Strengthened capital and liquidity requirements increase banks' resilience to unexpected shocks by giving them a larger cushion to absorb losses. Major UK banks' aggregate capital ratios are more than three times higher than before the GFC and leverage ratios require banks to hold capital in proportion to the size of their balance sheet.[5] This protects against risks that are more difficult to measure through risk models alone.

2.21 The UK's resolution regime was established by the Banking Act 2009, of which a key element was the introduction of 'bail-in' powers for the Bank of England. This allows the Bank of England to use debt and equity that is held by investors to absorb losses and recapitalise a bank. Banks are required to hold a minimum amount of debt and equity that can be bailed-in. This minimum is called "MREL" (or Minimum requirement for own funds and eligible Liabilities). This enables a bank to continue operating without taxpayer support.

2.22 Aside from the vast regulatory reforms that have been implemented, there have been significant changes to the environment in which UK banks operate. These include the growth of non-bank financial services, technological advances that continuously impact the evolution of practices in retail banking, and competition in services such as payments from fintech companies.

2.23 Against this backdrop of change since the ICB, the Panel has assessed the ring-fencing regime's impact and has made its recommendations to address the current environment and how things might evolve further in the future.

International perspective on banking reforms

2.24 During the Review, a number of regulators in other countries were consulted, including the Swiss Financial Market Supervisory Authority (FINMA), the US Federal Deposit Insurance Corporation and the US Federal Reserve, the National Bank of Belgium, the German Federal Ministry of Finance, the Monetary Authority of Singapore, the Hong Kong Monetary Authority and the Financial Services Agency of Japan.

2.25 **In comparison with other jurisdictions, the UK is an outlier when it comes to the implementation of structural separation.** Most countries did not implement any form of structural separation for their banks, and the handful of countries that did took a different, less rigid approach than the UK. Where other countries have implemented restrictions on what activities a bank can and cannot engage in, such as proprietary trading, the deposit-taking entities are still able to engage in a much wider scope of activities than RFBs in the UK.

2.26 The Panel considered whether the UK was unique in terms of the size of its banking sector relative to its economy. This has previously been cited as a reason for a stricter approach in the UK compared to other countries. However, the relative size of the UK's banking sector has reduced markedly since 2008 and is currently comparable to France, and much smaller than jurisdictions such as Singapore and Hong Kong, as shown in Table 2.1.

5. *Bank of England, December 2020, Financial Stability Report. Available at www.bankofengland.co.uk/financial-stability-report/2020/december-2020.*

Table 2.1: Banking system assets as a share of nominal GDP

Country	Assets / GDP 2008	Assets / GDP 2010	Assets / GDP 2016	Number of Banks 2016
Hong Kong SAR	630%	692%	829%	195
Singapore	643%	548%	586%	128
United Kingdom	**531%**	**502%**	**392%**	**366**
France	384%	392%	388%	529
Switzerland	193%	207%	283%	261
Belgium	359%	310%	261%	90
Germany	311%	324%	250%	1888
Australia	216%	196%	246%	82
Japan	159%	169%	204%	370
United States	94%	86%	91%	5913

Source: Bank for International Settlements [6]

Singapore and Hong Kong regulators indicated during consultation that instead of ring-fencing measures to maintain financial stability in their jurisdictions, they have focused on ensuring that banks do not engage in excessive risk-taking and have healthy capital and liquidity buffers. They also noted the importance of a Board and senior management team that can create the appropriate culture, with risk management capabilities appropriate for the complexity of the activities undertaken. Further details on the approaches taken by other countries to structural reforms or prohibitions are set out in Box 2.1.

Box 2.1: Approach of other countries to banking reforms

United States (US)

The United States banned proprietary trading by banks and in general has more restrictions in place than most other countries on what activities deposit-taking entities can engage in. Sections 16 and 21 of the Banking Act of 1933 (Glass-Steagall) cover the activities that investment banks and deposit-taking banks are allowed to engage in. Section 21 prohibits investment banks from receiving deposits. Section 16 prohibits deposit-taking banks from engaging in investment banking activities such as underwriting and dealing in securities.

Furthermore, the deposit taker's interactions with entities within the same banking group are strictly limited by Sections 23A and 23B of the Federal Reserve Act. ICB Chairman, Sir John Vickers has described these arrangements as "a light form of ring-fencing.[7]

In this respect, the US rules bear similarity to the UK's ring-fencing regime. However, the UK regime is stricter on the activities RFBs can engage in. For example, RFBs are only allowed to operate within the EEA and are prohibited from having exposures to Relevant Financial Institutions (RFIs), restrictions not imposed on US deposit-taking institutions.

6. *Bank for International Settlements, January 2018, Structural changes in banking after the crisis. Available at https://www.bis.org/publ/cgfs60.pdf. 2016 is the latest available data with a consistent cross-country comparison.*
7. *Sir John Vickers, 2012, Some Economics of Banking Reform.*

Switzerland

Swiss laws do not impose explicit structural separation requirements, ban proprietary trading, specify the exclusion of certain services, or place restrictions on deposit takers regarding the type of customers that they can bank. In that sense, there is no ring-fencing regime in Switzerland.

The Swiss resolution authority (FINMA) has used its resolution powers to require two of its banks that are Global Systemically Important Banks, Credit Suisse and UBS, to demonstrate that they have in place emergency plans to ensure the continuation of their systemically important functions in a resolution scenario.[8] In order to meet this requirement, Credit Suisse and UBS undertook changes to the corporate structure that somewhat resemble a ring-fence.

The Swiss banks moved their Swiss domestic businesses into separate legal entities, designed to remain viable even if the rest of the group entered insolvency. The domestic entities are insulated from the rest of the group and they have their own capital and liquidity requirements and service providers. These domestic entities are not authorised to provide investment banking services or engage in proprietary trading, apart from some market-making functions.

Germany

Under German law, deposit-taking banks may perform both retail and non-retail activities in principle. A ring-fencing regime applies only if these banks' trading assets exceed certain thresholds.[9, 10]

When the threshold is breached, the bank is prohibited from engaging in certain high-risk activities such as certain types of proprietary trading. Alternatively, the bank can instead "ring-fence" these activities by transferring them to a separate legal entity that is economically, organisationally and legally independent. The prohibitions relate to proprietary business, lending and guarantee business with certain hedge funds, foreign alternative investment funds, and high-frequency trading, provided this is not conducted as market-making. The prohibition does not apply to a business that is used to hedge client transactions, manage the institution's interest rate, foreign exchange (FX) or liquidity risks, or purchase or sell long-term participation.

Furthermore, the German National Competent Authority (NCA) can order a prohibition irrespective of whether the thresholds mentioned are exceeded. The NCA can also order - on a case-by-case basis - other transactions such as market-making to be ceased or transferred.

In practice, no entity has ever been ring-fenced as deposit takers have managed their activities to stay below relevant thresholds or stopped them altogether.

8. *See the Swiss Banking Act of 8 November 1934, the Swiss Banking Ordinance of 30 April 2014, the Swiss Capital Adequacy Ordinance of 1 June 2012, and the Swiss Bank Liquidity Ordinance of 30 November 2012.*

9. *"Trading assets" is shorthand for the following items on the balance sheet: "financial assets available for trading purposes" and "available for sale" or "trading portfolio" and "liquidity reserve".*

10. *Thresholds are (1) "trading assets" exceed €100 billion, or (2) the balance sheet total of the institution or of the group reaches at least €90 billion and the "trading assets" exceed 20% of the balance sheet total.*

Chapter 3

Impacts on financial stability

Key findings

- **Ring-fencing has contributed to a more resilient retail banking system through the creation of RFBs that are easier to supervise.**
- **Ring-fencing has not increased the resilience or improved the supervision of less complex banks in scope of the regime that do not undertake excluded activities.**
- **Non-retail entities of a bank (NRFBs) provide critical functions to the UK economy, a consideration that is not addressed by the ring-fencing regime.**
- **The ring-fencing regime has been less successful in reducing the implicit government guarantee and addressing too-big-to-fail, one of its key objectives.**
- **The resolution regime is designed to manage the failure of a whole bank in an orderly way, including RFBs and NRFBs. This provides a more comprehensive solution for addressing too-big-to-fail.**
- **If the resolution regime cannot manage the failure of a bank, then ring-fencing does not provide a comprehensive backstop option, leaving taxpayers at risk.**
- **The resolution regime is mostly structure-agnostic and so ring-fencing is not a pre-requisite for improving the resolvability of banks.**
- **The Panel considered the risks to financial stability as a result of ring-fencing. NRFBs have a lower resilience to a liquidity stress than an RFB due to less available collateral that can be used to access Bank of England emergency facilities. In addition, RFBs are less diversified and more concentrated in the UK mortgage market.**

Benefits of ring-fencing for retail banking resilience

3.1 When assessing the impacts of the ring-fencing regime, the objectives set out in Chapter 2 that the ICB and HM Treasury were aiming to achieve were taken into account. **It is the Panel's view that the ring-fencing regime has contributed to a more resilient retail banking system**. It has achieved this through:

- creating distinct retail deposit-taking entities that are well capitalised and liquid;
- enabling easier supervision of RFBs in large, complex banks; and
- protecting the retail component of a failing bank in some very narrow scenarios (such as when a failure is caused by an NRFB) by making it easier for the authorities to carve it out.

Retail entities that are well capitalised and liquid

3.2 **Since the GFC, various banking reforms have contributed to making retail banks in the UK more resilient.** Many reforms were driven globally, such as increasing capital and liquidity requirements. As a result, Common Equity Tier 1 (CET1) ratios for groups subject to ring-fencing are now more than three times 2007 levels, as shown in Figure 3.1. Similarly, RFBs hold around 1.5 times the High-Quality Liquid Asset buffer required to meet 30-day stressed outflows under the Liquidity Coverage Requirement, as shown in Figure 3.2.

3.3 The capital and liquidity frameworks are complemented by a wide range of domestically driven reforms such as Bank of England annual stress tests for the larger UK banks, recovery and resolution planning, and stronger accountability via the SM&CR.

Figure 3.1: CET1 capital ratio of groups subject to ring-fencing[1,2]

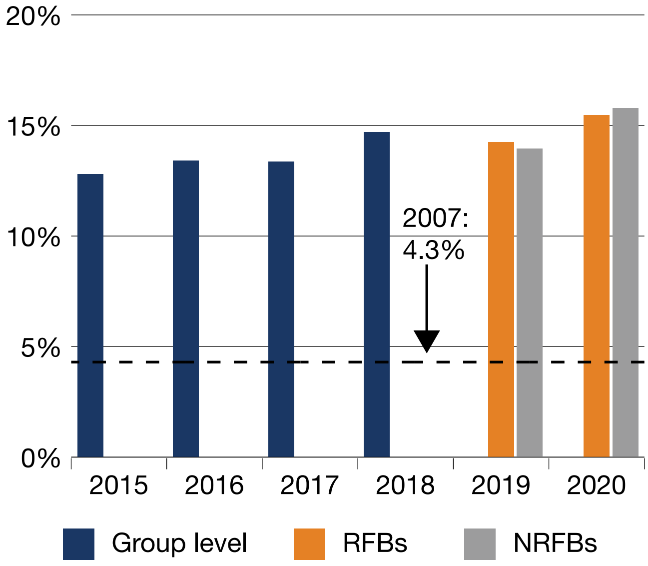
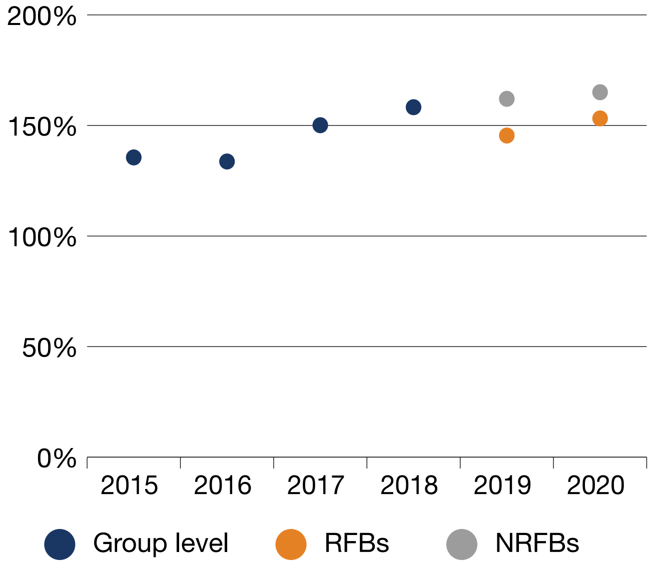


Figure 3.2: Liquidity Coverage Ratio of groups subject to ring-fencing[3]



Sources: Submissions from PRA, Bank of England Financial Stability Report and RFPT Review calculations

3.4 Ring-fencing has contributed towards the resilience of retail banks. RFBs are well capitalised and liquid and provide the retail component of a large bank with its additional buffer to withstand losses (known as the 'Other Systemically Important Institutions', O-SII buffer), which only applies to RFBs and building societies above a certain size.

3.5 It is difficult to directly quantify the contribution of the ring-fencing regime to the resilience of retail banking relative to other reforms. However, it is the Panel's view that at a minimum, the ICB's recommendations paved the way for the widespread regulatory change since the GFC.

Enabling easier supervision of RFBs

3.6 **Ring-fencing has helped facilitate better supervision of RFBs in large, complex banks.** The regime has not changed the PRA's fundamental approach to how it supervises banks. However, in discussions with the Panel, the PRA outlined its view that RFBs are now easier to supervise due to their relatively simple and transparent business models and products, independent governance arrangements, and bespoke supervisory processes. The Panel agrees with the PRA's view, based on the assessment that:

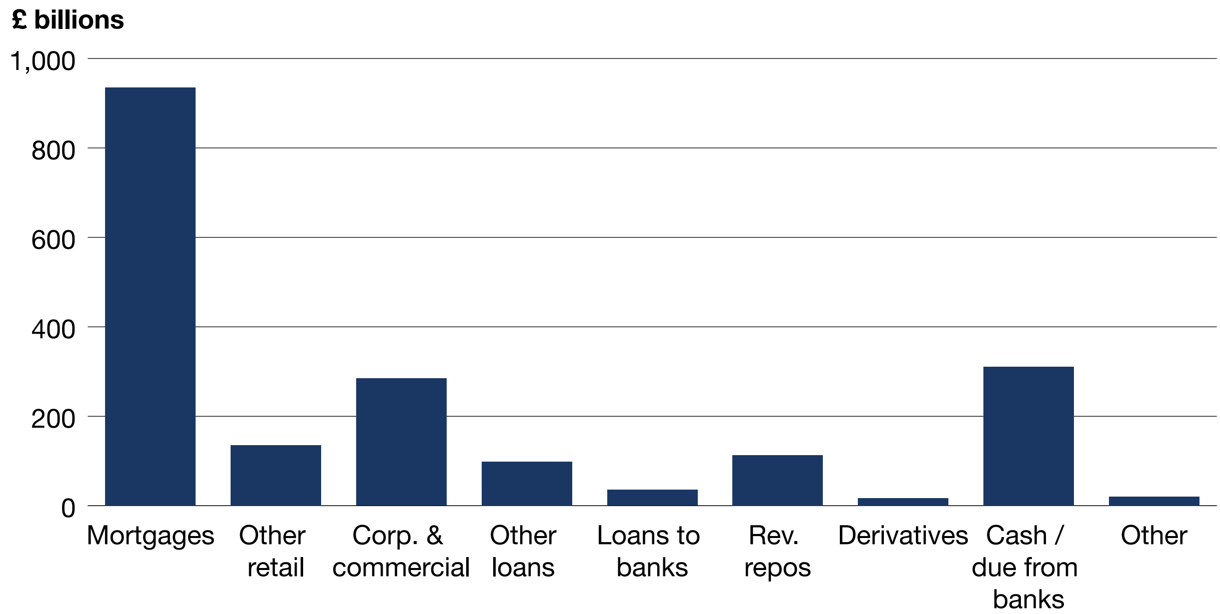
- RFBs' assets are predominantly made up of mortgages and commercial loans, while retail customer deposits account for most of their liabilities (Figure 3.3 and Figure 3.4).
- Independent governance arrangements, which are discussed further in Chapter 5, support supervision by ensuring that RFB Boards have strong leadership focused specifically on the

1. *Year-end median ratios for Barclays, HSBC UK, Lloyds Bank plc, NatWest Group, Santander UK, TSB Bank, and Virgin Money.*
2. *2007 ratio of 4.3% is aggregate CET1 for major UK banks as reported in July 2021 Financial Stability Report.*
3. *Year-end median ratios for Barclays, HSBC UK, Lloyds Bank plc, NatWest Group, Santander UK, TSB Bank, and Virgin Money.*

business of RFBs. This provides an added assurance that Board members understand their business and associated risks.

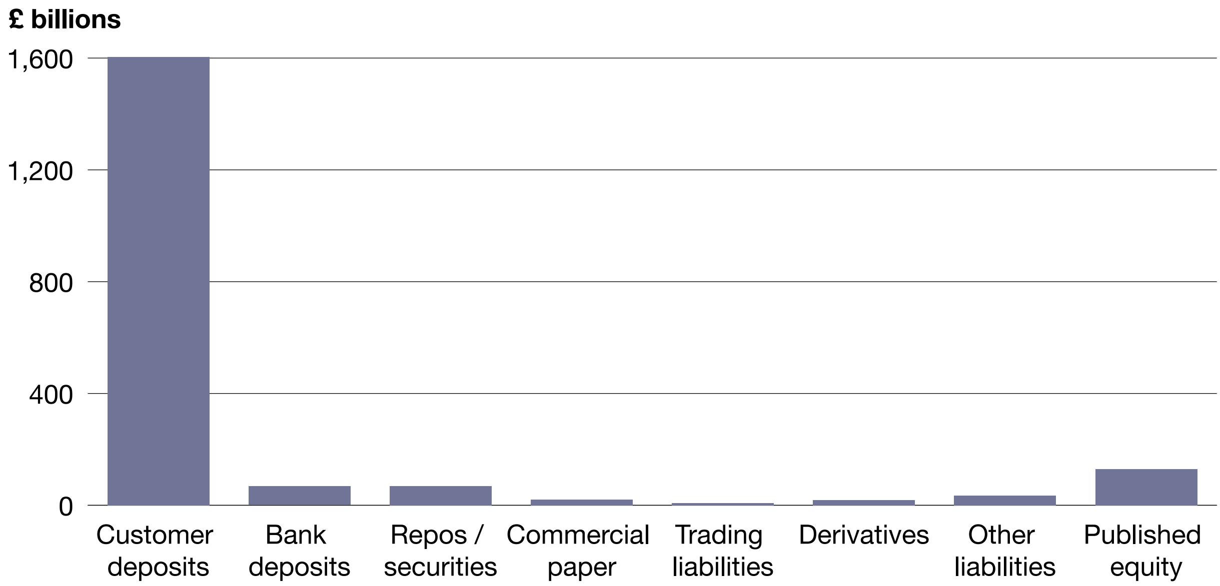
- RFBs undergo more effective regulatory scrutiny due to greater transparency, enhanced reporting, and individual requirements for key supervisory documents such as ICAAPs (Internal Capital Adequacy Assessment Process) and ILAAPs (Internal Liquidity Adequacy Assessment Process).

Figure 3.3: Aggregate composition of RFBs' assets for year-end 2020[4]



Source: Data from Fitch Solutions

Figure 3.4: Aggregate composition of RFBs' liabilities for year-end 2020[5]



Source: Data from Fitch Solutions

4. *Barclays, HSBC UK, Lloyds Bank plc, NatWest Group, Santander UK, TSB Bank, and Virgin Money.*
5. *Barclays, HSBC UK, Lloyds Bank plc, NatWest Group, Santander UK, TSB Bank, and Virgin Money.*

3.7 In the future, this will be further strengthened by stress testing being undertaken for the RFB, rather than only at group level. This will provide regulators with a more granular assessment of risks on the balance sheet of an RFB, and their individual resilience to stress scenarios.

3.8 The third benefit of the ring-fencing regime regarding protecting the retail component of a failing bank is discussed in more detail later in this chapter.

Limitations of the ring-fencing regime

3.9 As already noted, the Panel considered the impacts of the ring-fencing regime on financial stability relative to the original aims of the ICB and HM Treasury. **While some of these have been achieved as previously outlined, analysis has identified a number of areas where the regime has been less successfu**l. In particular:

- ring-fencing has not increased the resilience of less complex banks within the regime;
- the benefits of increased resilience, better supervision, and better protection are relevant only for RFBs, not NRFBs and the wider group; and
- evidence suggests that the reduction in the implicit government guarantee and the progress in addressing too-big-to-fail is not attributable to ring-fencing.

Financial stability benefits of ring-fencing are relevant only for RFBs in large, complex groups

3.10 For banks that do not undertake excluded activities as shown in Figure 2.1, the benefits of having them in the ring-fencing regime are less apparent. Banks in this category already had a simple and transparent business model that was easy to supervise prior to ring-fencing. Some banks in the regime have almost no activity outside of the RFB. For the same reasons that building societies are outside the scope of the ring-fencing regime, there is no benefit in structurally separating banks that do not engage in excluded activities. This is because the RFB is not being ring-fenced from any excluded activities, and so there is no reduction in complexity or risk for the RFB, which is the main benefit of ring-fencing that the Panel has identified.

Reduction in implicit government guarantee is not attributable to ring-fencing

3.11 A central question during the Review was around the benefits of ring-fencing in the context of too-big-to-fail. It relates to the view that some banks are so instrumental to the economy due to the critical services that they provide, that a disorderly failure would result in a severe shock to the financial system and economy. The only alternative is government financial support to keep the bank open to ensure continuity of these services. This is discussed in more detail later in this chapter. To begin with, the contribution of ring-fencing addressing too-big-to-fail is analysed by measuring the impact on the implicit government guarantee.

3.12 The implicit guarantee relates to the assumption that governments will always bail out banks that are considered ‘too-big-to-fail’. In theory, creditors lend to these banks at a lower price as the risk of failure is perceived to be lower, reducing the cost of borrowing for banks. Reducing this implicit guarantee was another objective of the ring-fencing regime as noted in Chapter 2. A reduction in the implicit guarantee should curb excess risk-taking by banks as the cost of borrowing would more accurately reflect the risk that the bank is taking.

3.13 **The evidence shows that the value of the implicit government guarantee has been significantly reduced since the GFC, but this has been attributed to other factors, including the development of the resolution regime rather than ring-fencing.**

3.14 The Bank of England estimated that the value of the implicit guarantee to UK bank shareholders fell from around £45 billion in 2010 to less than £5 billion at the end of 2016.[6] The Financial Stability Board (FSB) assessed that the implicit guarantee had been reduced globally for systemically important banks.[7] Both identified the developments in resolution regimes as the key drivers in reducing the implicit guarantee, with neither making any attribution to the ring-fencing regime in the UK.

3.15 The credit ratings of banks were also analysed to find any evidence of ring-fencing reducing the implicit guarantee. Evidence provided by the credit rating agencies (CRAs) Moody's, Fitch, and S&P suggests that the introduction of the Bank Recovery and Resolution Directive (BRRD) in 2015 was the main driver behind the reduction in the number of notches for government support in their credit ratings for UK banks.[8] Equally, the CRAs do not view ring-fencing as a major factor in why the implicit guarantee for banks is much lower today.

3.16 **The Panel concluded that ring-fencing has not played a significant role in reducing the implicit guarantee, which is supported by the estimates of the Bank of England and the FSB, and the views of the CRAs.** This conclusion is also supported by the evidence relating to the importance of NRFBs in providing critical functions and the role of the resolution regime, which is discussed later in this chapter.

Critical functions and the importance of NRFBs

3.17 As outlined earlier in the chapter, the ring-fencing regime was successful in achieving some of its objectives. In particular it created separate RFBs that are well capitalised, it made it easier to supervise RFBs, and it protects RFBs of any failing bank making it easier for the authorities to carve it out. Yet despite this, the evidence shows that the reduction in the implicit government guarantee was not driven by ring-fencing but rather the resolution regime. The Report explores this further to understand the key drivers.

Critical functions – an evolving concept

3.18 **The concept of banking functions that are critical to the economy has evolved globally and widened in scope since it was raised by the ICB in its 2011 report.** The ICB concluded that the services isolated by a ring-fence should be those where continuous provision is critical to the economy. The ICB report specifies that critical services, or what it called "mandated" services, are taking deposits from, and providing overdrafts to, individuals and SMEs.[9]

3.19 While these services are indeed critical, it is increasingly recognised that a much wider set of activities must also be treated as critical. This is most notable in the context of resolution regimes developed globally to manage the failure of banks. In 2014, the FSB set out guidance with examples of the critical functions that a bank provides.[10] Critical functions are defined by the PRA to include investment banking activities, corporate banking activities, lending between financial institutions, as

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6. *Dave Ramsden, 2021, The UK's progress on resolvability. Available at https://www.bankofengland.co.uk/speech/2021/february/dave-ramsden-institute-of-chartered-accountants-in-england-wales#:~:text=Dave%20Ramsden%20talks%20about%20what,it%20is%20known%20as%20resolution.*

7. *Financial Stability Board, 2021, Evaluation of the Effects of Too-Big-To-Fail Reforms: Final Report. Available at https://www.fsb.org/wp-content/uploads/P010421-1.pdf.*

8. *CRAs assess the credit worthiness of companies and their ability to repay debt by assigning a rating or "notch" on a scale. In general, if a company receives an additional notch it is viewed to be more credit worthy.*

9. *ICB, September 2011, Final Report.*

10. *FSB, 2013, Guidance on Identification of Critical Functions and Critical Shared Services. Available at https://www.fsb.org/wp-content/uploads/r_130716a.pdf.*

well as other activities.[11] Since ring-fencing aims to insulate the RFB from risks associated with some of these activities, they are prohibited from being inside an RFB. As a result, critical functions are now also carried out in NRFBs, making NRFBs more essential than the ICB envisaged. Table 3.1 sets out the typical critical functions that RFBs and NRFBs provide.

Table 3.1: Critical functions typically provided by RFBs and NRFBs[12]

Critical functions provided by RFBs	Critical functions provided by NRFBs
• Retail & SME current accounts • Retail & SME savings accounts • Retail mortgages • Retail secured lending • Retail credit cards • Payments, settlement, & cash services • Corporate deposits & lending	• Corporate deposits & lending • Trade finance • Infrastructure lending • Credit card merchant services • Derivatives • Trading portfolios • Securities financing & lending • Payment services • Settlement services • Custody services

Importance of NRFBs

3.20 As noted earlier in the chapter, the benefits of the ring-fencing regime in terms of increased resilience, better supervision, and better protection are relevant only for the retail components of a bank, not NRFBs and the wider group.

3.21 **The Bank of England submitted evidence that in the event of a bank failure, insolvency whereby a bank ceases operating and its assets and liabilities are 'wound down', would not likely be a credible option for an NRFB that provides critical functions.** The financial stability impacts would be material for the UK economy. This means that parts of the NRFBs would also need to be protected in the event of a banking group failing, rather than just the RFBs. If a major UK bank fails, the option created by the ring-fencing regime to carve out the RFB while placing the NRFB into insolvency, would not be a viable option for the authorities.

3.22 **If relying on the ring-fencing regime alone, the government would be faced with the unenviable choice of either providing taxpayer support or risking severe consequences for the wider financial system and economy.** In that respect, the ring-fencing regime alone would not make it easier to manage a failing bank in an orderly manner without the need for taxpayer funds.

Importance of the resolution regime

3.23 Following the GFC, the Special Resolution Regime for banks was introduced through the Banking Act 2009. It provides the Bank of England with a set of legal powers to ensure resolution is an orderly process, which allows it to maintain critical functions, protect public funds, and protect financial stability.[13] A background explanation of the regime is set out in Annex D.

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11. *PRA, 2014, The Prudential Regulation Authority's approach to banking supervision. Available at https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/approach/banking-approach-2014.pdf.*

12. *Information from bank publications and Bank of England's confidential resolution plans and resolvability assessments. The critical functions described are an indicative summary and not necessarily exhaustive.*

13. *Bank of England, Resolution webpage. Available at https://www.bankofengland.co.uk/financial-stability/resolution.*

Evolution of the resolution regime

3.24 Since the ICB's recommendations in 2011, a lot of work has gone into establishing a credible resolution regime. This includes ensuring that a bank has debt liabilities that can be used to recapitalise the bank if it gets into financial difficulty while maintaining the critical functions that the bank provides.

3.25 The resolution regime has evolved significantly, in particular with the introduction of the BRRD in 2015. Around the same time, the Banking Act was amended to introduce a new objective for the Bank of England to ensure the continuity of all critical functions regardless of whether they sit in the RFB or NRFB. This reflects the importance of the NRFB.

3.26 The Panel also recognises that the critical function of deposit taking is very important for the economy. In ensuring the continuation of all critical functions when a bank fails, the resolution regime would protect the critical function of deposit taking.

3.27 While the ring-fencing regime is silent on the critical functions provided by NRFBs, the resolution regime acknowledges the importance of NRFBs and aims to manage the failure of an NRFB alongside the RFB. Therefore, the resolution regime provides a more comprehensive solution to tackling the failure of a large UK banking group that contains both an RFB and an NRFB. This is supported by the evidence regarding the impact of the resolution regime in reducing the implicit government guarantee outlined earlier in this chapter.

3.28 **Without the resolution regime, and with critical functions on both sides of the ring-fence, taxpayers would remain financially exposed if forced to rely on the ring-fencing regime alone to manage the failure of a bank.** In other words, the ring-fencing regime does not act as a comprehensive backstop if the resolution regime is unable to manage a bank failure.

3.29 Whilst it could not have been foreseen by the ICB in the aftermath of the GFC, the evolving regulatory landscape throughout the past decade has resulted in two regimes that are not aligned in the way they aim to address too-big-to-fail, adding complexity to regulation in the UK. In essence, the ring-fencing regime was an earlier attempt at addressing too-big-to-fail with a focus on a narrow set of critical functions. But it is the resolution regime that is now better placed to provide a comprehensive solution for tackling this issue.

Interaction between the ring-fencing and resolution regimes

3.30 **As noted earlier, the ring-fencing regime explicitly prioritises the resilience of RFBs over NRFBs.** In contrast, the resolution regime recognises the importance of NRFBs and aims to manage the failure of both. This creates an inconsistency between the regimes, where the resilience of an RFB is prioritised over an NRFB, but in a failure, the critical functions of both are recognised as being important.

3.31 The detailed unpublished resolution plans and assessments of all banks in scope of the ring-fencing regime and the published Statements of Policy of the Bank of England were analysed.

3.32 Based on this evidence, the Panel concluded that ring-fencing does not play an important role in improving the resolvability of banks. First, the resolution regime is mostly structure-agnostic. The only "structural" expectation seems to be that banks who need to hold MREL (Minimum requirement for own funds and eligible liabilities) above minimum capital requirements need to structurally subordinate MREL by setting up a clean holding company.

3.33 Second, ring-fencing is not a pre-requisite for achieving resolvability. To be considered resolvable, a bank must meet three resolvability outcomes: financial resilience; continuity and restructuring; and coordination and communication. To achieve these outcomes, it must meet expectations set out in eight underlying statements of policy.[14] The only area where the Panel views ring-fencing as relevant is "Restructuring Planning".

3.34 **The Panel recognises that ring-fencing has the potential to facilitate resolvability in so far as it could reduce the time and cost of the post-resolution restructuring process.** In the restructuring phase of resolution, ring-fencing can theoretically provide the optionality to handle different parts of a bank separately, as noted earlier in the chapter.

3.35 If an issue arises in one part of a banking group, for example the NRFB, ring-fencing may reduce the reputational damage for the other parts of the group. Given the existing separation of management and business lines, it could also increase the value for buyers interested in purchasing RFB assets and liabilities. Buyers may be less likely to take retail assets and deposits that are in the same legal entity as the 'bad assets' that caused the failure. Ring-fencing could prevent this 'tainting' of the RFB, making the resolution more orderly. Equally, the rigidity of the regime may mean the assets are mainly attractive to another RFB rather than any buyer outside the regime, so attractiveness may be limited.

3.36 In any case, this potential benefit is limited to a narrow set of scenarios, as it would only be realised where the failure of a bank was caused by activities taking place in an NRFB only. Given the exposures of banks subject to ring-fencing, it is not a certainty that failure would come about solely due to NRFB activities. There are more scenarios where banks could fail across multiple business lines and across the ring-fence, and as a result, would require restructuring involving both the RFB and NRFB. In these scenarios, the structural benefits of ring-fencing separation are not relevant.

3.37 Furthermore, in a resolution situation, it is even possible that provisions of the ring-fencing regime may have to be disapplied, so that they do not become an obstacle to an orderly resolution. The orderly resolution of a large banking group might need to allow for the deployment of capital, liquidity and resources in a way that would not be compatible with how the ring-fencing regime would operate in normal circumstances. The potential options are explored further in Box 3.1.

3.38 **The benefit of structural separation under the ring-fencing regime is time-limited.** To meet the objective of continuity and restructuring under the Resolvability Assessment Framework (RAF), banks must maintain robust restructuring planning capabilities rather than a form of *ex-ante* separation. In other words, the resolution regime does not require banks to undertake any restructuring or separation as long as they are able to plan and execute restructuring effectively and in a timely way in the event of a resolution.

3.39 Most banks within the ring-fencing regime are in scope of the reporting and disclosure requirements of the RAF. Under the RAF these banks must self-assess their resolvability, including their restructuring planning capabilities. Banks and the Bank of England will make the first disclosures under the RAF in June 2022. The Panel's view is that after the point at which the restructuring capabilities of banks are assessed as robust, the theoretical benefit of ex-ante separation under the ring-fencing regime falls away.

[14.] *The eight underlying barriers are: MREL; Valuations; Funding in resolution; Continuity of financial contracts in resolution; Operational continuity in resolution; Continuity of access to Financial Market Infrastructure; Restructuring planning; and Management, governance, and communications. Statements of Policy on each are available at https://www.bankofengland.co.uk/financial-stability/resolution.*

BOX 3.1: Role of ring-fencing in the resolution process

In resolution, key parts of the ring-fencing regime can be disapplied

Over the "resolution weekend", many of the ring-fencing provisions could be disapplied to enable an orderly resolution process to take place.[15] The bail-in resolution strategy is intended to be carried out at the financial holding company level, not the individual RFB/NRFB level, and the Bank of England might need to disapply key ring-fencing provisions to facilitate an orderly resolution.

A resolution involving bail-in might well be carried out at the financial holding company level, not the individual RFB/NRFB level, and the Bank of England might choose to disapply key ring-fencing provisions to facilitate an orderly resolution of this type. In resolution, excess capital in the RFB might, if necessary, even be used to support the NRFB, and vice versa. To facilitate this, ring-fencing restrictions could be disapplied.

As with capital, liquidity from the RFB or NRFB could be deployed by the resolution authority to where it is most needed.

The usual governance arrangements could also be set aside in a resolution: the Bank of England could appoint a Bail-in Administrator (BIA) or exercise full control of the bank directly.

Theoretical benefits of ex-ante structural separation are unlikely to materialise fully

After the "resolution weekend" in the restructuring phase of the resolution process, the existing structures of ring-fencing have theoretical benefits insofar as they could reduce the time and cost of the post-resolution restructuring needed. This assumes that restructuring is not required across both the RFB and NRFB, and 'bad' assets are confined to the balance sheet of the NRFB only.

However, examples of previous banking crises indicate that banks typically incur losses in both the trading and the banking books. This means that banks with universal banking models are unlikely to fail solely due to the investment banking activities of the NRFB, but rather also due to the retail banking activities of the RFB as outlined in the following examples.

Royal Bank of Scotland (RBS)

There are multiple reasons why RBS failed following the GFC, as the FSA report that considered this question makes clear. But it is not the case that it was brought down by its investment banking activities alone.[16] As can be seen from Table 3.2, both the trading book and banking book sustained heavy losses (£18 billion and £32 billion respectively over 2007-2010).

15. *The resolution process and the "resolution weekend" are explained in detail in Annex D.*

16. *FSA, 2011, The failure of the Royal Bank of Scotland. Available at https://www.fca.org.uk/publication/corporate/fsa-rbs.pdf.*

Table 3.2: RBS losses 2007 – 2010 (£mn)

	2007	2008	2009	2010	Total losses
Loss on credit trading	1,430	12,200	4,108	(41)	17,697
Impairment of goodwill	40	30,062	363	10	30,475
Impairment losses on loans and advances	2,106	7,091	14,134	9,144	32,475
Total losses	3,576	49,353	18,605	9,113	80,647

Source: RBS Annual Report & Accounts

Other bank failures

More fundamentally, lessons from the history of banking failures in the UK indicate that almost all the failed banks had heavy commercial and/or retail real estate exposures. During the GFC, there were several examples - HBOS, Northern Rock, Bradford and Bingley, and Dunfermline Building Society - where none engaged in investment banking.

Should another crisis occur of sufficient magnitude to result in a failure of any of the banks in the ring-fencing regime, it appears highly unlikely that losses would emerge only from the NRFB. Therefore, the benefit of having a relatively independent RFB, while giving some optionality to the authorities, is likely to be limited as further restructuring, including of the RFB, may be required. The resolution regime recognises this reality. That is why under the resolution regime, a business reorganisation plan would only be finalised sometime after the resolution weekend. This is to provide the failed bank and the authorities time to understand the causes of failure and what reorganisation needs to take place to restore long-term viability.

Financial stability risks

3.40 Aside from the financial stability impacts in relation to the intended objectives of the regime, the risks to financial stability as a result of ring-fencing were also analysed. First, NRFBs appear more vulnerable to extreme liquidity stresses. Second, the ring-fencing regime has resulted in RFBs with credit risk concentrated in the UK mortgage market.

NRFBs' vulnerability to liquidity stresses

3.41 **Evidence suggests that NRFBs have lower resilience to severe liquidity stresses than RFBs, as they have fewer contingency options available.**[17] This is in part because NRFBs are more prone to liquidity outflows and do not have large amounts of eligible collateral that is considered to be of high enough quality to pre-position with the Bank of England to access its liquidity insurance facilities in times of stress.

17. *Based on Call for Evidence responses, Bank of England liquidity stress test results and PRA supervisory information.*

3.42 These facilities complement the self-insurance banks maintain under the Bank of England's liquidity regime by allowing banks to borrow cash from the central bank.[18] Although NRFBs are required to hold large buffers of liquid assets to withstand the risks they face, it would not be realistic or efficient to expect them to self-insure against every conceivable stress.

3.43 Furthermore, NRFBs have fewer 'sticky' deposits relative to their RFB counterparts. This is because: (i) their businesses consist of greater activity with corporates and financial institutions that tend to have greater liquidity demands during stresses, and necessarily have more funding exposure to counterparties; and (ii) only a tiny fraction of customer deposits held by NRFBs are covered by the Financial Services Compensation Scheme relative to their RFB counterparts (Figure 3.5 and Figure 3.6). This makes NRFB deposits 'flightier' and can exacerbate the structural vulnerability identified.

Figure 3.5: Proportion of deposits held by RFBs covered by FSCS[19]

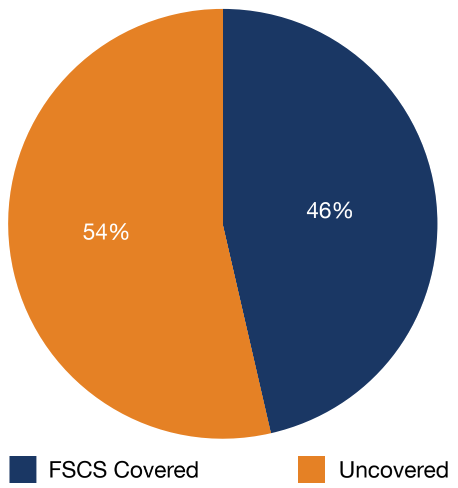
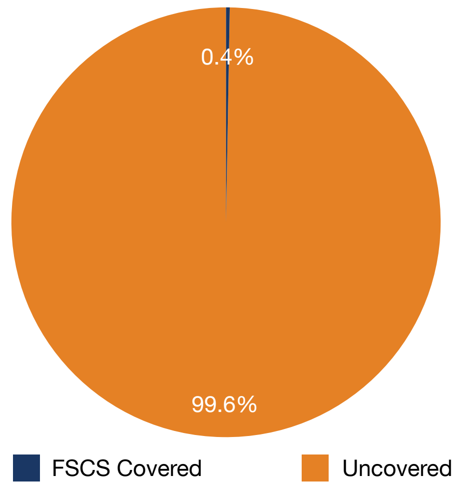


Figure 3.6: Proportion of deposits held by NRFBs covered by FSCS[20]



Source: Submissions from Bank of England

Concentrated exposures to the UK mortgage market

3.44 **Ring-fencing has resulted in RFBs whose credit risks are more concentrated in the UK mortgage market than is the case for the group as a whole.** UK retail mortgages constitute more than 80% of RFBs' lending, which may heighten the risk of failure due to increased sectoral risk concentration.[21] However, this risk is mitigated by various factors including additional capital add-ons as part of Pillar 2 assessments, stress testing and enhanced supervision of RFBs.

3.45 Some stakeholders responding to the Call for Evidence also argued that ring-fencing has caused increased risk-taking by other banks engaged in mortgage lending, faced with increased competition from RFBs. The evidence suggests that any such effects are likely to have been driven by other factors, which is discussed in more detail in Chapter 4.

18. *Background on the Bank of England's liquidity insurance framework is available at https://www.bankofengland.co.uk/markets/bank-of-england-market-operations-guide/our-objectives.*

19. *Total deposits of £1,900 billion as at 31 December 2020.*

20. *Total deposits of £1,700 billion as at 31 December 2020.*

21. *Individual RFB figures range from 72% to 92% based on submissions from FCA.*

3.46 **But the Panel is reassured that RFBs' distance to failure is still large as a consequence of the wider reforms.** The Bank of England, based on its stress tests, concludes that UK banks are resilient to severe economic shocks, including a stress scenario where UK residential and commercial property prices fall by around 33%.[22] The Panel's confidence in the stress tests would be higher if they were conducted at the RFB level, which will be the basis of future stress tests from 2022 onwards.

Conclusions

3.47 The ring-fencing regime has achieved some, but not all of its intended objectives. Ring-fencing has contributed to improving UK financial stability, but the regime has been less successful in its key objectives of reducing the risk to public funds and addressing too-big-to-fail. These objectives are being addressed primarily by the resolution regime, which is therefore overtaking the ring-fencing regime.

3.48 The Panel concluded that in the short term, taxpayers remain financially exposed in a scenario where a large UK bank fails. Based on the assessments of the Bank of England, the Panel acknowledges that the distance to failure for UK banks is large at present. However, the UK does not operate a zero-failure regime and therefore the risk to public funds needs to be addressed.

3.49 In the longer term, there is a risk that retail banking in the UK ossifies and remains focused on addressing the risks and opportunities of the past, rather than being able to adapt to address the risks and opportunities that may arise in the future. The Panel sees value in prioritising the more dynamic approach of the resolution regime in reducing risks to public funds, as it will continue to play a more prominent role than the ring-fencing regime. This forms the basis of the recommendations in Chapter 7.

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22. *Bank of England, December 2021, Financial Stability Report. Available at https://www.bankofengland.co.uk/financial-stability-report/2021/December-2021.*

Chapter 4

Impacts on competition and competitiveness

Key Findings

- **Excess liquidity buffers held by RFBs have increased markedly. However, this has been driven by increased deposits, and government and central bank interventions in response to the Covid-19 pandemic rather than the ring-fencing regime.**
- **The ring-fencing regime has not had a noticeable impact on competition in retail banking markets to date, nor has it acted as a barrier to entry or growth for smaller banks.**
- **Competition in the UK mortgage market is high. The evidence suggests that ring-fencing may have contributed to the fall in mortgage rates available to customers, but overall, other factors have been driving this trend.**
- **The ring-fencing regime has had some impact on the competitiveness of UK banks through a range of factors including increased funding costs for NRFBs, but so far the impact has been limited.**
- **The evidence suggests that the ring-fencing regime has not had a material impact on the supply of credit for UK corporates, including small and medium-sized enterprises (SMEs).**
- **Although the impacts of the regime have been limited so far, should key influential factors impacting the banking sector change, such as monetary policy and funding conditions, there is the potential for ring-fencing to result in material impacts on competition and competitiveness in the future.**

Background

4.1 The ring-fencing regime was intended to promote financial stability and minimise risks to public funds. It was recognised that the benefits to the economy would come from ensuring the resilience of the banking sector, which is critical in supporting economic growth and reducing the costs of future financial crises. In addition, the ICB specifically noted the potential competition benefits to the banking sector of introducing ring-fencing. In particular, it argued that by reducing the implicit government guarantee that larger banks benefit from, the ring-fencing regime would push lenders to price the debt of larger banks to better reflect their risks. This would remove the unwarranted competitive advantage in funding that larger banks have over smaller banks and therefore promote competition.[1]

4.2 Alongside these competition benefits, the ICB acknowledged that the regime would impose “private” costs on the banks in setting up new structures and operating within the regime, which are explored in Chapter 5.

4.3 **Isolating the impact of the ring-fencing regime is challenging because there have been other significant drivers for the banking sector since the regime was brought into legislation in 2013.** These drivers include monetary policy stimulus and banks’ strategic business decisions over the last decade. More recently, there have been stressed market conditions during the Covid-19 pandemic, government support programmes, and central bank interventions in the market. These factors may have neutralised or masked impacts linked to the ring-fencing regime. The Report therefore focuses on identifying whether impacts can be confidently attributed to the regime. As banks started

1. *ICB, September 2011, Final Report, page 160.*

changing business structures to prepare several years before the regime came into force in 2019, data trends have been analysed over longer time periods where possible. Where the evidence is not definitive, or conclusions cannot be explicitly drawn, this is stated in the Report.

4.4 This chapter starts with an outline of the impacts of the ring-fencing regime on funding and liquidity in RFBs and NRFBs. This analysis has implications for the impacts on competition and competitiveness that are set out in the rest of the chapter.

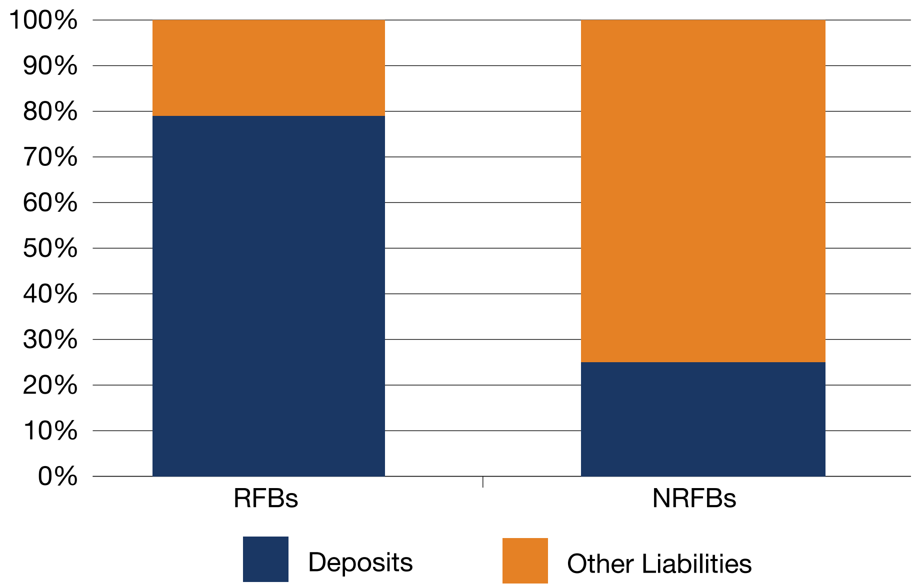
4.5 The analysis of impacts on competition focuses on the retail banking sector and therefore primarily considers the role of RFBs and their competitors. Meanwhile, the analysis on competitiveness focuses on UK banks' ability to compete with international players, which is primarily related to the operations of NRFBs and the attractiveness of the UK as a place to do banking.

Funding and liquidity in the UK banking sector

4.6 Ring-fencing, by design, requires liquidity to be placed on either side of the fence. It prevents NRFBs from using retail deposits to fund investment banking activities. Whilst banks have some discretion in setting their business model and structure as outlined in Chapter 2, the regime has resulted in a change to the funding mix in the retail and non-retail parts of banks.

4.7 **This resulted in a concentration of deposit funding inside RFBs with a lower level of deposit funding in NRFBs.** A Bank of England staff working paper estimated that the change in structure caused RFBs' share of funding from retail deposits to increase on average by 18 percentage points, while NRFBs saw an average reduction of 45 percentage points.[2] Figure 4.1 depicts the variation of overall deposits in the funding mix of both RFBs and NRFBs in aggregate.

Figure 4.1: Funding mix for RFBs and NRFBs as at end 2020



Source: Data from Fitch Solutions

2. *Bank of England, Staff Working Paper, 2020, Separating retail and investment banking: evidence from the UK. Available at https://www.bankofengland.co.uk/working-paper/2020/separating-retail-and-investment-banking-evidence-from-the-uk.*

Excess liquidity in banks

4.8 Some stakeholders suggested that liquidity in RFBs is underutilised, and specifically that deposits that were previously deployed in non-retail markets have not yet been fully absorbed into retail markets, leading to a proportion of liquidity not being used.

4.9 Several metrics were analysed to consider the extent to which banks were unable to deploy liquidity due to the ring-fencing restrictions, including Liquidity Coverage Ratios (LCRs) and Loan-to-Deposit Ratios (LDRs).

4.10 The LCR is a regulatory measure of liquidity introduced by the Basel Framework and can be used as an indicator of excess liquidity. LCRs measure the ability of banks to meet cash outflows in a stress scenario over a certain period, usually 30 days. This is to ensure that a bank can withstand a potential 'run' in extreme cases. The minimum LCR requirement for all banks, known as Pillar 1, is 100%, which means that banks must hold sufficient liquidity to meet all expected outflows in a 30-day period. Regulators also require individual banks to hold additional liquidity based on bank-specific risks, referred to as Pillar 2 requirements.

4.11 RFBs set internal LCR targets above the minimum regulatory requirements to ensure that they always remain above these levels. Banks' liquidity positions fluctuate during the month as the result of customer behaviour, so month-end liquidity positions are often higher than intra-month positions.

Table 4.1: LCRs of five largest RFBs

Bank	31-Dec-18	31-Dec-19	31-Dec-20
Barclays RFB	164%	144%	160%
HSBC UK RFB	143%	165%	198%
Lloyds Bank RFB	-	127%	126%
NatWest Group RFB	-	145%	152%
Santander UK RFB	164%	142%	150%

Source: Data from Fitch Solutions

4.12 After the ring-fencing regime came into effect in January 2019, the change in actual LCRs of the largest five RFBs varied, as shown in Table 4.1. Whilst the LCRs of the Barclays and Santander UK RFBs saw a reduction, HSBC UK's RFB saw an increase. However, the LCRs across all but one of the five largest RFBs saw a significant increase in 2020.

4.13 Since the start of the Covid-19 pandemic, liquidity has increased substantially for banks globally due to ongoing monetary policy stimulus from central banks, and in the UK the availability of cheap funding from the extension in 2020 of the Bank of England's Term Funding Scheme (TFSME). The TFSME provides funding support to incentivise banks to lend, which RFBs used to draw down £36 billion in 2020.[3] At the same time, deposits grew as a result of households spending less and saving more. For RFBs, retail deposit growth was high, with an aggregate increase of £186 billion between December 2019 and December 2020.[4]

3. *Bank of England TFSME data. Available at https://www.bankofengland.co.uk/markets/bank-of-england-market-operations-guide/results-and-usage-data.*
4. *Data from Fitch Solutions.*

4.14 **Analysis shows that aggregate excess liquidity above internal LCR targets held by the five largest RFBs was £120 billion in September 2021.**[5] This is significantly above pre-Covid-19 levels of £40 billion in March 2019. Banks' submissions during the Review attributed the increase to the Covid-19 pandemic. Confidential evidence from the regulators shows banks and building societies outside of the ring-fencing regime also have excess liquidity.

4.15 **However, it is unknown how much of this additional bank liquidity will be temporary or permanent.** The Monetary Policy Committee's central projection assumes that households will spend around 10% of additional accumulated savings over its three-year forecast period to Q4 2024.[6] Also, some excess liquidity is expected to fall away as government and central bank schemes, including the TFSME, become due for repayment. TFSME funding has terms of up to four years, although over £15 billion of the £54 billion drawn by RFBs has already been repaid.[7]

4.16 Some stakeholders also cited the LDR, which is the ratio of loans to deposits, as an indicator of excess liquidity in RFBs. While this metric might illustrate the proportion of deposits that a bank has deployed, it does not take account of any regulatory liquidity requirements or internal liquidity targets of a bank.

Table 4.2: LDRs of five largest RFBs

Bank	31-Dec-18	31-Dec-19	31-Dec-20
Barclays RFB	95.66	96.59	86.62
HSBC UK RFB	86.05	85.44	74.97
Lloyds Bank RFB	110.72	110.45	101.82
NatWest Group RFB	87.87	90.87	85.29
Santander UK RFB	113.49	114.51	107.73

Source: Data from Fitch Solutions

4.17 The LDRs of each of the five largest RFBs stayed relatively stable through 2019, the first year that ring-fencing was in force, as shown in Table 4.2. However, through 2020 each saw a significant reduction. This highlights the increase in deposits relative to loans. Taken together with increasing LCRs and increasing retail deposits of £186 billion, a falling LDR indicates that the recent increase in liquidity has not been fully deployed into the retail banking markets.

4.18 **Although it is plausible that ring-fencing might have resulted in a large proportion of liquidity being underutilised in RFBs, the regime has not been a driver of the increase in excess liquidity in RFBs.** This increase has been primarily down to Covid-19 related factors.

4.19 At this early stage, it is difficult to be certain whether the recent increase in liquidity is temporary or more sticky. Depending on customer decisions, central bank monetary policy and other funding and liquidity schemes, as well as individual bank strategies and risk appetites, the constraints imposed

5. *Based on confidential information received from banks, as at 30 September 2021. One RFB drew a large amount of TFSME in October 2021, therefore data as at October 2021 data was used for that RFB.*

6. *Bank of England, 2021, Monetary Policy Report November 2021. Available at https://www.bankofengland.co.uk/monetary-policy-report/2021/november-2021.*

7. *Bank of England TFSME data.*

by ring-fencing may result in this liquidity being deployed in retail banking markets. However, to date there is not evidence of significant impacts on retail banking markets as discussed later in the chapter.

Competition in the UK retail banking market

4.20 As part of reviewing competition in the UK banking sector, a number of issues were analysed, including changes to lending that could have arisen as a result of the increased liquidity outlined previously, and changes to market pricing for a number of different retail products.

4.21 In undertaking this analysis, the focus was to understand the potential impacts of ring-fencing on competition while acknowledging previous reviews that have already found that large UK banks have a competitive advantage over smaller banks and building societies.[8] This competitive advantage has been attributed to large and stable customer bases built up over generations, brand familiarity, large branch networks, and aspects of the wider regulatory framework. These issues pre-date ring-fencing.

4.22 **However, the purpose of this chapter is not to re-affirm the existence of advantages for large banks but rather to consider whether ring-fencing has created new advantages or compounded existing ones.** This is sometimes difficult, as ring-fenced banking groups are also the large incumbent banks.

4.23 There are a number of retail banking markets considered in this chapter. Aside from the mortgage and SME lending markets, RFBs compete in markets to provide loans to customers, and to attract customer deposits in savings and current accounts.

4.24 The retail operations of the seven banks in the ring-fencing regime have been undertaken in RFBs since 2019. For ease of presenting analysis in this chapter, when comparing data on the retail operations of these banks over the time period before 2019, they are also referred to as RFBs.

Retail lending markets

4.25 RFBs' market share in most of the retail loan markets has generally been flat or in the case of motor finance, has been falling as shown in Figure 4.2. The absolute amounts of lending in these markets are very small compared to the mortgage market, at £130 billion compared to £1.3 trillion of mortgage lending as of 2021.[9] However, it appears that, to the extent that RFBs have acquired additional liquidity, it has not translated into increased share in these markets.

4.26 Gross lending has been increasing year on year for both RFBs and competitor firms outside the regime. The scale of growth in RFB lending has been broadly consistent at between 3% and 4% until the Covid-19 pandemic in 2020 and 2021, when it increased to 4.9% and 5.5% respectively.

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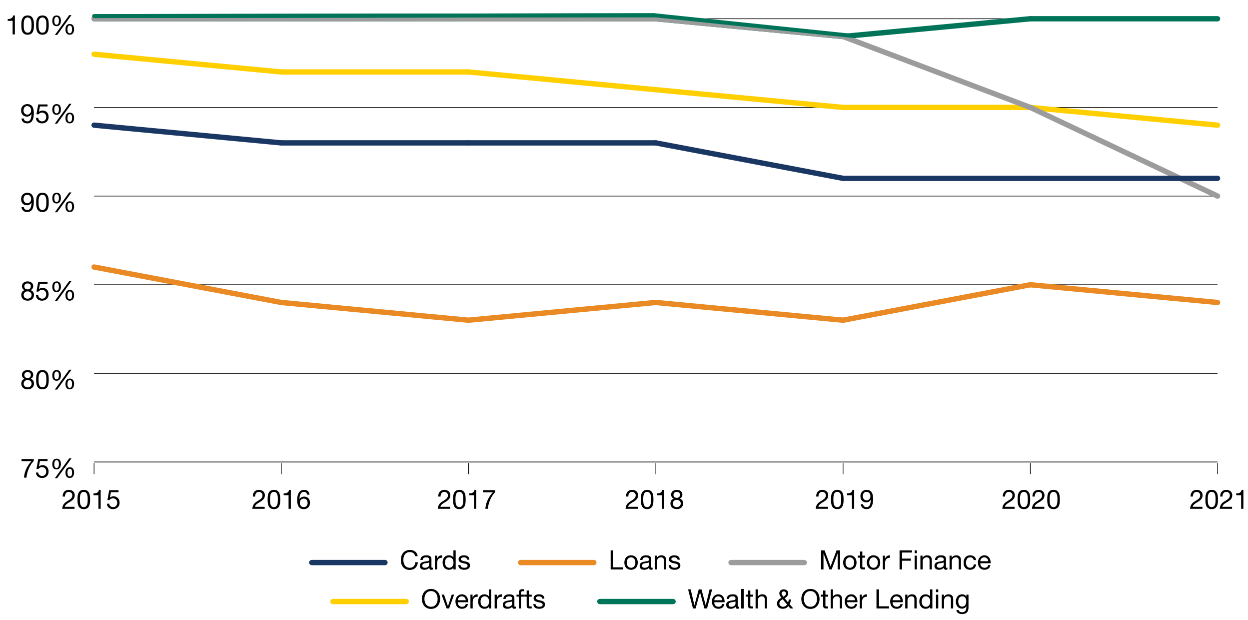
8. *CMA, 2016, Retail banking market investigation Final report. Available at https://assets.publishing.service.gov.uk/media/57ac9667e5274a0f6c00007a/retail-banking-market-investigation-full-final-report.pdf.*
FCA, 2022, Strategic Review of Retail Banking Business Models – Final Report. Available at https://www.fca.org.uk/publication/multi-firm-reviews/strategic-review-retail-banking-business-models-final-report-2022.pdf.

9. *Based on confidential FCA representative market data containing seven RFBs and seven competitor firms.*

Figure 4.2: RFBs' market share in lending[10]



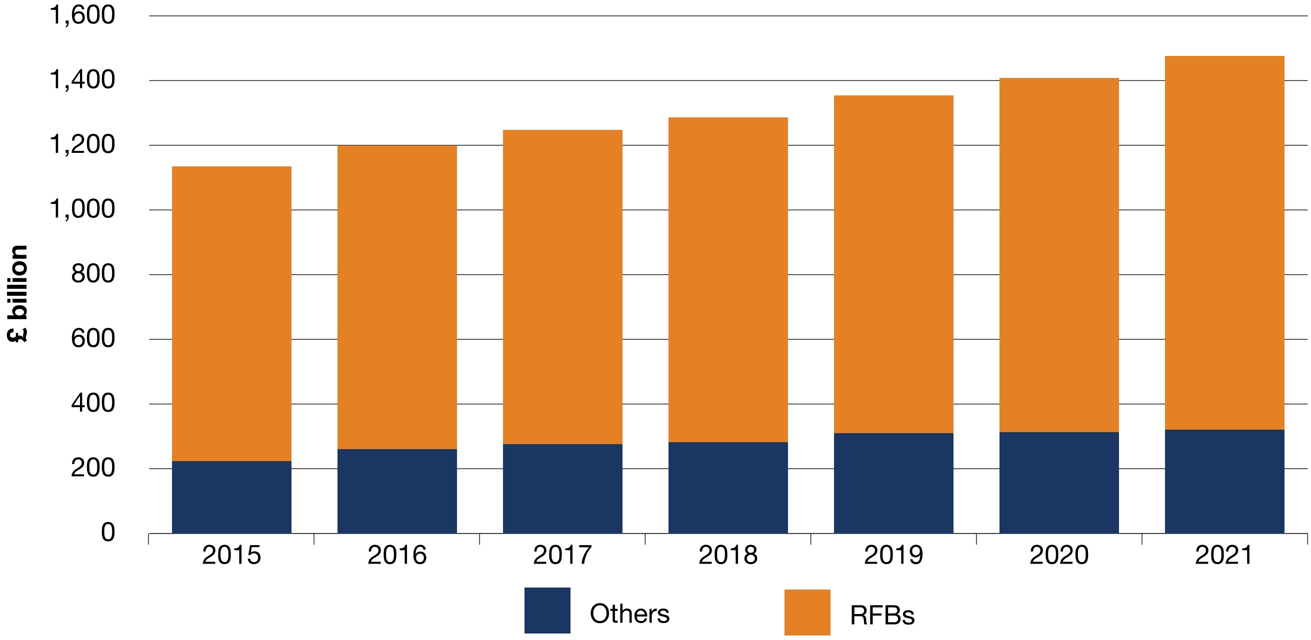
Source: Submissions from FCA

4.27 For competitor firms, growth has also been consistently positive, albeit more volatile year-on-year. Overall, since 2015 competitor firms have increased their lending by 43% compared to 27% for RFBs.[11] As lending increased for RFBs and their competitors alike, these results are consistent with the findings discussed under liquidity. Gross lending growth by RFBs did not materially increase following the introduction of the ring-fencing regime or the influx of liquidity (Figure 4.3).

4.28 A lack of increase in market share for RFBs could be due to the response of banks and building societies outside the ring-fencing regime. The profitability or quality of what is provided by competitors, which could be negatively affected by such a response was not examined. But the positive indications from the FCA retail banking update which states that competitive pressures and innovation are starting to deliver for customers, could suggest that the ring-fencing regime has not prevented competition from improving.[12]

10. *The markets are defined as per an FCA representative dataset for retail banks which comprises 14 firms.*
11. *Based on confidential data provided by the FCA.*
12. *FCA, 2022, Strategic Review of Retail Banking Business Models – Final Report', page 6.*

Figure 4.3: Gross lending of RFBs and competitors £bn[13]



Source: Submissions from FCA

Retail savings markets

4.29 Whilst RFBs' market share in deposit taking remains high, their share had been falling in the period to 2019, as shown in Figure 4.4. This decline slowed in the subsequent two years, while in the case of SME savings, RFBs' market share increased. This likely reflects the influx of deposits as a result of the Covid-19 pandemic, as discussed previously.

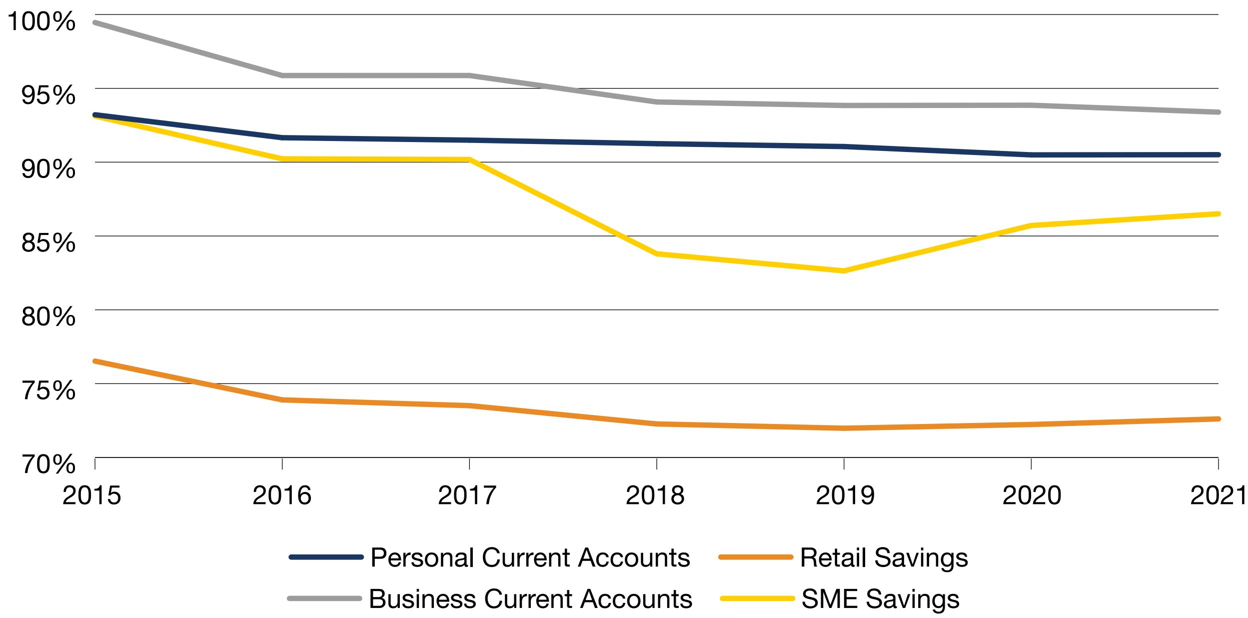
4.30 The significant funding cost advantage of RFBs over smaller players existed prior to the introduction of the ring-fencing regime and is primarily driven by the size and make-up of their deposit base. In addition, unpublished research from the Bank of England made available during the Review shows that funding costs and prices sometimes move in opposite directions, which illustrates that other factors can be more important when it comes to pricing and competition.

4.31 RFBs have consistently paid lower interest on deposits than their competitors, long before the introduction of ring-fencing, as illustrated in Figure 4.5. **While monetary policy is a key factor driving interest rates lower, the relative interest rates paid by RFBs compared to their competitors post-2019 have not seen a discernible decrease, suggesting that RFB savers are not worse off as a consequence of ring-fencing.** Similarly, the UK Finance response to the Review's Call for Evidence noted that "there is little observable impact from ring-fencing on deposit pricing."[14]

13. The markets are defined as per FCA representative dataset for retail banks which comprises 14 firms.

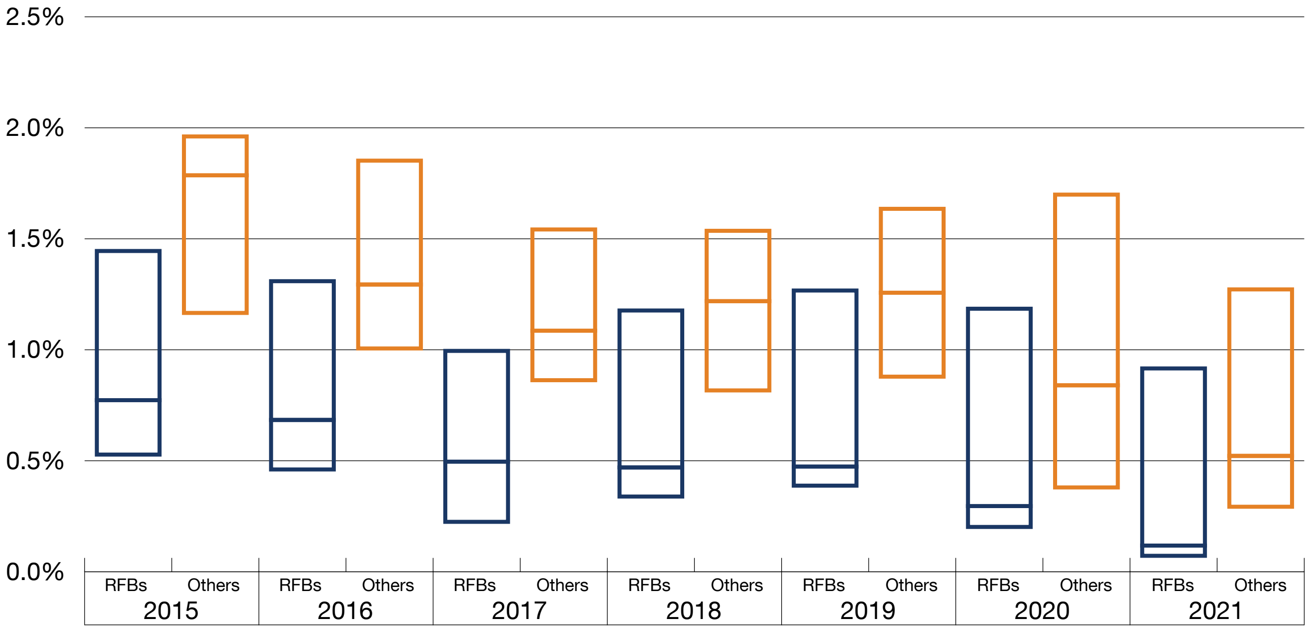
14. UK Finance response to the RFPT Review's call for evidence. Available at https://www.ukfinance.org.uk/system/files/UK%20Finance_RFPT%20review_response%20to%20call%20for%20evidence_June%202021.pdf.

Figure 4.4: RFBs' market share in deposit taking[15]



Source: Submissions from FCA

Figure 4.5: Range of "interest rates" paid by RFBs compared to competitor firms[16]



Source: Submissions from FCA

4.32 The analysis also considered the impact of banks outside the ring-fencing regime that are able to use retail deposits to fund higher risk and return activities. In theory, they should be able to offer higher rates to savers and therefore ring-fencing could be causing saving rates to be suppressed by preventing this riskier activity in RFBs.

15. *The markets are defined as per an FCA representative dataset for retail banks which comprises 14 firms.*

16. *Figure 4.5 shows the minimum, median and maximum for two groups – RFBs and competitor firms. 'Interest rates paid' is calculated using the interest paid by each firm divided by the average balance of savings held for the year.*

4.33 During consultations with stakeholders, it was noted that market-leading rates offered by Marcus UK, an example of a bank operating outside the ring-fencing regime, were short-lived. This is to be expected as it approached the £25bn deposit threshold given its strategy to stay below the threshold. Additionally, some RFBs confirmed that they had not adjusted rates in response to the new entrant, which may again be expected given the large quantities of liquidity available to banks.

4.34 On the face of it, ring-fencing does not appear to have caused a change in the market shares of RFBs across either the retail lending markets or retail savings markets.

4.35 **The Panel concluded that to date, the ring-fencing regime is unlikely to have impacted UK retail banking markets, even when considering the additional liquidity held by RFBs since the Covid-19 influx.**

4.36 As outlined in the liquidity section, it is unclear what will happen to the Covid-19 induced liquidity. In the scenario where this ends up being deployed in retail banking markets, it will likely increase competition for borrowers and drive down prices, though any potential impacts in the UK savings market are less clear.

Barriers to entry and expansion for challenger banks

4.37 The difficulties that challengers face when competing with larger banks are well documented, for example, in the FCA retail banking review.[17] That review, based on pre-2019 data, concluded that major banks with large personal current account (PCA) networks have a competitive advantage over other business models, including paying lower interest rates on deposits in PCAs and savings accounts.

4.38 In the FCA update published this year, it reiterated that low levels of customer engagement have historically contributed to high barriers to entry and expansion in retail banking.[18] The FCA review also found that large banks are in a strong position but face increasing competition.

4.39 During consultations challenger banks did not state that ring-fencing was a significant constraint on their businesses. Those that did engage during the Review cited other constraints such as:

- Challenges faced by smaller banks issuing MREL.
- RFBs holding less lending capital than smaller banks, as they use internal capital models rather than the standard capital models.
- Government lending schemes, such as the Coronavirus Business Interruption Loan Scheme (CBIL) and bounce back loans (BBL), initially relied on RFBs. As an example, the BBL scheme launched with seven of the largest banks. Other lenders were added incrementally. Nearly 90% of the total value of BBLs was provided by the five largest lenders.[19]
- RFBs have a lower cost base that comes with scale, which most challengers have yet to achieve.

4.40 New entrants into the UK retail banking market since the introduction of ring-fencing legislation indicates that the ring-fencing regime has not acted as a barrier to entry. Starling launched in 2014, the Spanish bank Sabadell purchased TSB in 2015, and JPMorgan Chase launched its UK retail bank in 2021.

17. *FCA, 2018, Strategic Review of Retail Banking Business Models – Final Report, page 3.*
18. *FCA, 2018, Strategic Review of Retail Banking Business Models – Final Report, page 9.*
19. *National Audit Office, 2020, Investigation into the Bounce Back Loan Scheme, p34-35. Available at https://www.nao.org.uk/wp-content/uploads/2020/10/Investigation-into-the-Bounce-Back-Loan-Scheme.pdf.*

4.41 One notable exception is the launch of Marcus UK by Goldman Sachs in 2020, providing savings accounts. During consultations, Marcus UK made clear that the costs of compliance with ring-fencing made it unviable for its business to grow above the deposit threshold of £25 billion, limiting its ability to grow its savings business any further.

4.42 On balance, the Panel concluded that ring-fencing has not increased barriers to entry or growth for most competitor firms. Challenger banks remain well below the £25 billion deposit threshold for entering the regime, and the share of the deposit-taking market for competitor firms was increasing prior to the Covid-19 pandemic, as shown in Figure 4.4.

Competition in the UK mortgage market

4.43 Given the relative size and importance of mortgages in UK retail banking, the impacts on this market are analysed in more detail. In particular, this section looks at concentration in the mortgage market, the evidence provided by banks within the ring-fencing regime, changes to the market share of RFBs, and the pricing of mortgages. It is important to note that the relatively short period of time since the introduction of ring-fencing and the wider market factors at play, constrain the ability to draw definitive conclusions. As noted in the discussion around the potential future deployment of excess liquidity, future impacts may arise.

Concentration and market share of the mortgage market

4.44 Looking at the concentration of players in the mortgage market, the Herfindahl- Hirschman Index (HHI) is a widely accepted market concentration measure. If the HHI is under 1,000 the market is said to be unconcentrated; from 1,000 to 2,000 it is generally considered to be concentrated; and over 2,000 indicates high concentration.[20] The mortgage market HHI has marginally fallen since the introduction of the ring-fencing regime from 991 at the end of 2018, to 976 at the end of 2020, indicating an increasingly unconcentrated market.[21] This would suggest that the mortgage market is not excessively concentrated and that concentration has not been increased by the ring-fencing regime.

4.45 Market share figures vary depending on the market definition, time period analysed, and sample. For example, a Bank of England staff working paper concluded that the ring-fencing regime has resulted in increased mortgage market share for RFBs when calculated on a local market basis.[22,23] However, analysis of data from the FCA made available during the Review shows that the unadjusted mortgage market share for RFBs was stable between 69.1% and 69.0% in the three years to mid-2020, the period during which their mortgage offerings may have been impacted by the introduction of ring-fencing.[24] The mortgage market share for RFBs, in terms of number of mortgages, appears to have been falling over the same three-year period.

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20. *CMA, 2020, The State of UK Competition, p14. Available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/939636/State_of_Competition_Report_Nov_2020_Final.pdf.*

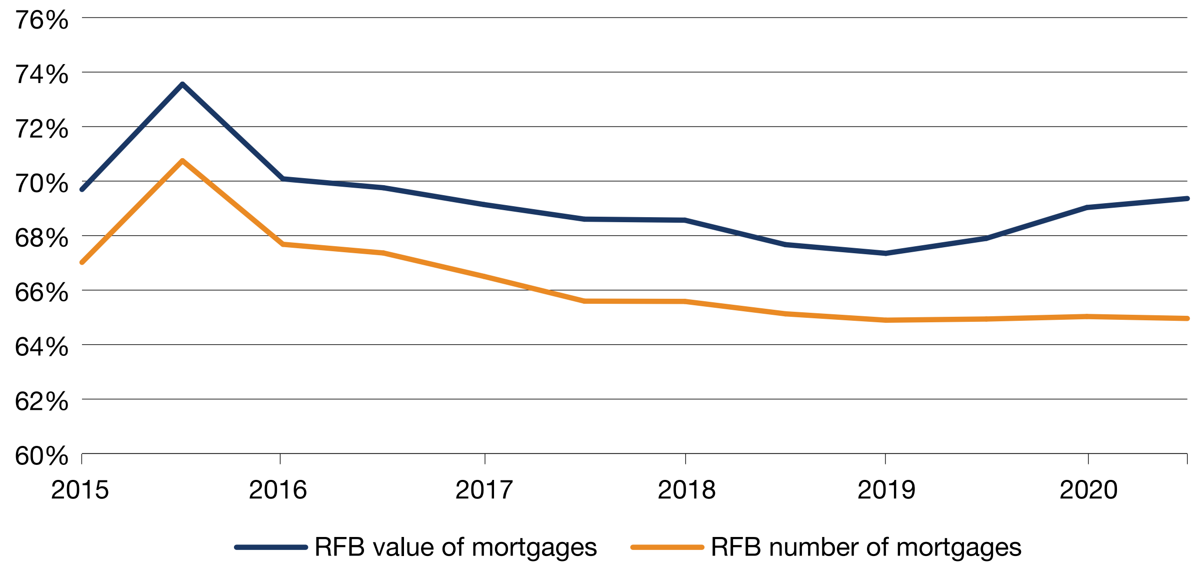
21. *Based on UK Finance published market share data between 2018 and 2020 and RFPT review calculations. Newer iterations available at https://www.ukfinance.org.uk/data-and-research/data/mortgages/largest-mortgage-lenders.*

22. *Bank of England, Staff Working Paper, 2020, Separating retail and investment banking: evidence from the UK.*

23. *Local markets were defined as a combination of product and property location, with latter measured at the district level. There was a total of 390 districts in the authors' sample. Product was defined by maturity and LTV.*

24. *Calculations based on confidential data provided by the FCA.*

Figure 4.6: RFBs' mortgage market share



Source: Submissions from FCA

4.46 As shown in Figure 4.6, the market share of RFBs for residential mortgages has reduced in terms of the number of mortgages but it has increased in terms of value since 2019. This indicates that post-2019, RFBs have increased their stock of higher value mortgages relative to other banks and building societies rather than increasing the number of mortgages.

4.47 **Submissions to the Call for Evidence were mixed as to whether the ring-fencing regime has impacted market shares in mortgages.** It was suggested that the impacts of the regime on the mortgage market should be evident from 2016 onwards as banks prepared for the regime.

4.48 The market share for building societies, which are not subject to ring-fencing, has continued to remain at or above the 21.5% it was in 2016.[25] The Building Society Association's submission noted that "The building society sector has broadly maintained its market share since 2019" after ring-fencing was implemented.[26]

Mortgage market pricing

4.49 The UK mortgage market has had a long-term trend of tightening spreads well in advance of ring-fencing legislation and implementation. Mortgages have continued to be competitively priced, especially for low loan-to-value (LTV) products.[27] The net interest margins of mortgage providers began to markedly fall around seven years before the introduction of the ring-fencing regime, as shown in Figure 4.7.

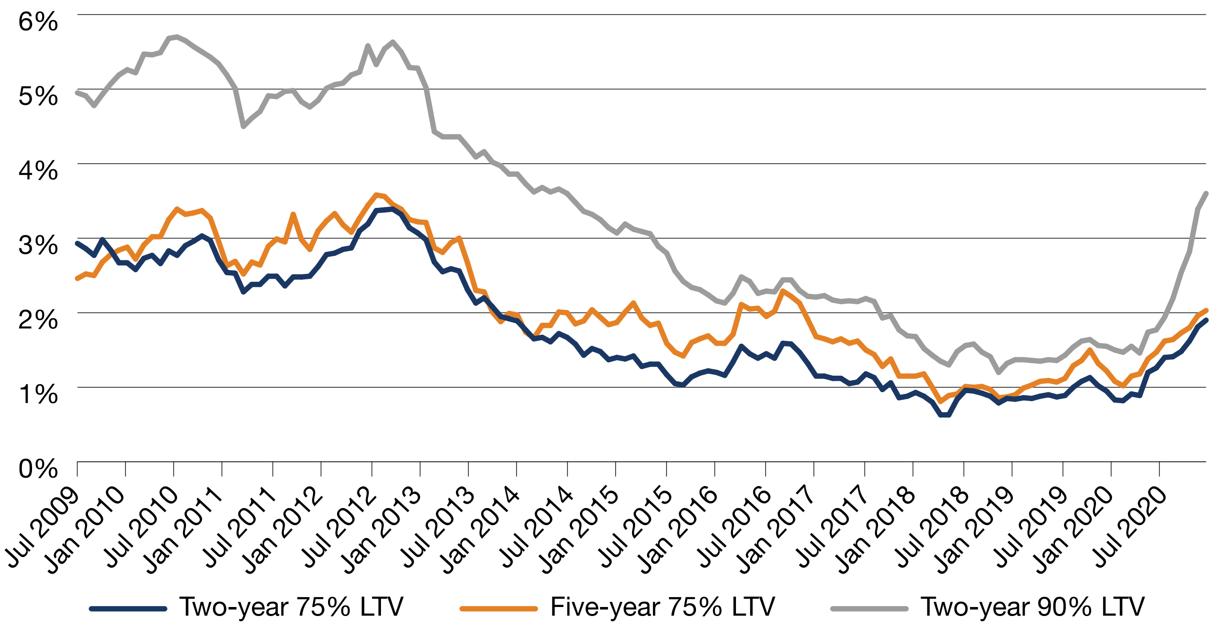
4.50 Although it is possible that banks acted well in advance of the implementation of the regime, there is no evidence to suggest that they adjusted pricing on mortgages, the majority of which are three-year fixed rate products, so far in advance due to the regime. More recently a clear increase in spreads since the onset of the Covid-19 pandemic can be observed, particularly for higher LTV mortgages.

25. *Calculations based on confidential data provided by the FCA.*

26. *BSA response to the RFPT Review's call for evidence. Available at https://www.bsa.org.uk/BSA/files/26/26a73df0-ec02-4b20-986b-9776e8ad33ad.pdf.*

27. *LTV is a percentage figure, representing the size of a mortgage relative to a property's value.*

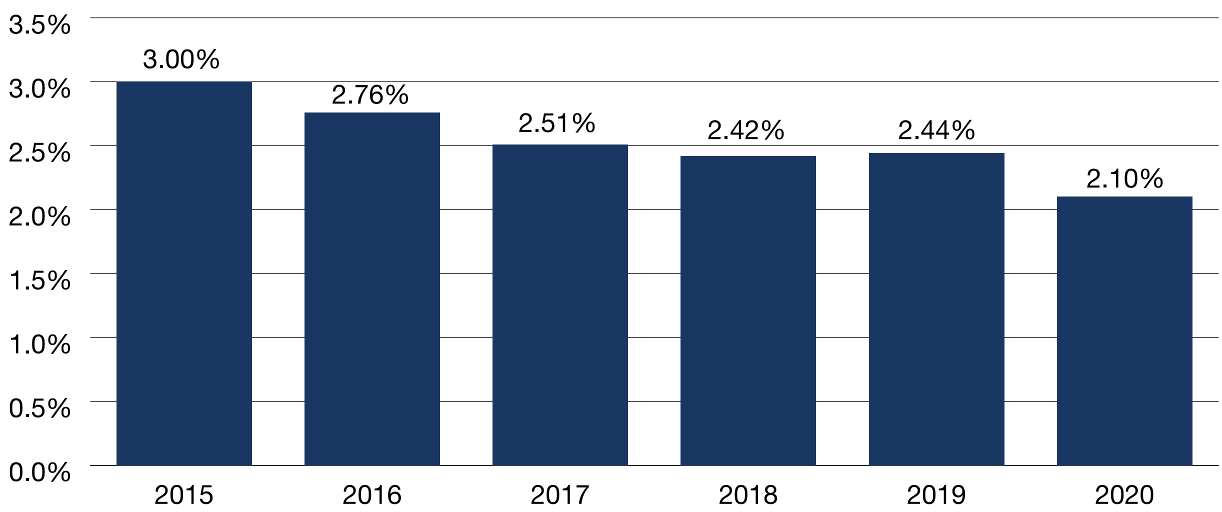
Figure 4.7: UK mortgage market spreads since 2009



Source: Bank of England, Financial Stability Report, December 2020

4.51 A Bank of England staff working paper suggested that the ring-fencing regime caused a 17-basis point decrease in mortgage spreads, or about 10% of the overall decline in mortgage spreads from 2013 to 2019.[28,29] The authors stated that ring-fencing contributed to a 'price war' but that it was not the main driver. The increasingly competitively priced mortgage market is also illustrated by steadily declining risk-adjusted yield figures in Figure 4.8.

Figure 4.8: Residential mortgages – risk-adjusted yields



Source: FCA Strategic Review of Retail Banking Business Models – Final Report 2022

28. *Bank of England, Staff Working Paper, 2020, Separating retail and investment banking: evidence from the UK.*

29. *Bank of England, Staff blog, 2020, Separating deposit-taking from investment banking: new evidence on an old question. Available at https://bankunderground.co.uk/2020/11/27/separating-deposit-taking-from-investment-banking-new-evidence-on-an-old-question.*

4.52 A range of other sources of information, including consultations with stakeholders, confirms that factors other than ring-fencing are judged to have been the main drivers in mortgage pricing. These factors include the Bank of England's Term Funding Scheme as previously discussed; banks' strategies; and sticky deposits which have been unresponsive to incentives from competitor firms and consequently retained in RFBs.

4.53 During the Review's consultations, HSBC specifically noted that post-2015, it reviewed its mortgage strategy and increased mortgage availability through brokers, but that this was not related to ring-fencing.

4.54 Overall, the trends observed since the introduction of the ring-fencing regime in 2019 have been in play for a long period. Balancing the mixed results of the quantitative analysis of the UK mortgage market, combined with the qualitative assessment of other driving factors discussed with the banks, led the Panel to conclude that **ring-fencing has had at most, a minor impact on mortgage spreads and that it is difficult to conclude that ring-fencing has impacted the approach of banks inside the regime**.

4.55 However, it is possible that impacts could materialise and become observable in the future over a longer period, in particular in response to existing excess liquidity.

Mortgage risk exposures for RFBs and their competitors

4.56 The impact of the ring-fencing regime on risk-taking in the mortgage market by banks was analysed. Based on a variety of metrics for RFBs, competitor banks, and building societies, **the Panel concluded that ring-fencing has not resulted in increased risk taking by banks**.

Figure 4.9: Proportion of RFB mortgages at high LTI[30]

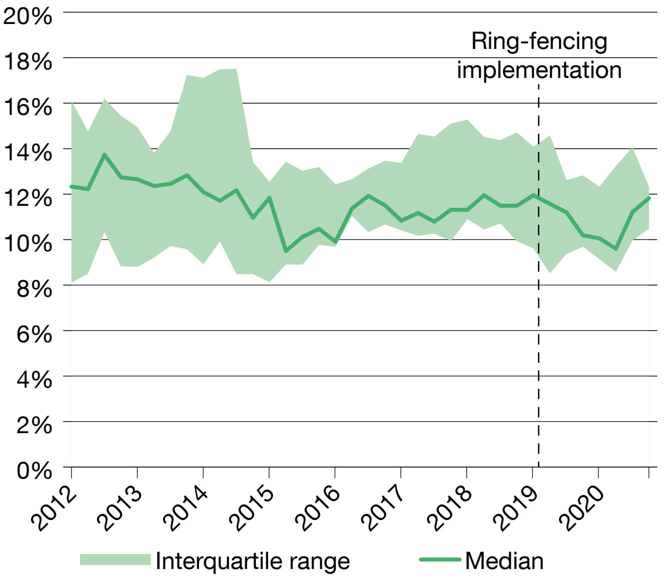
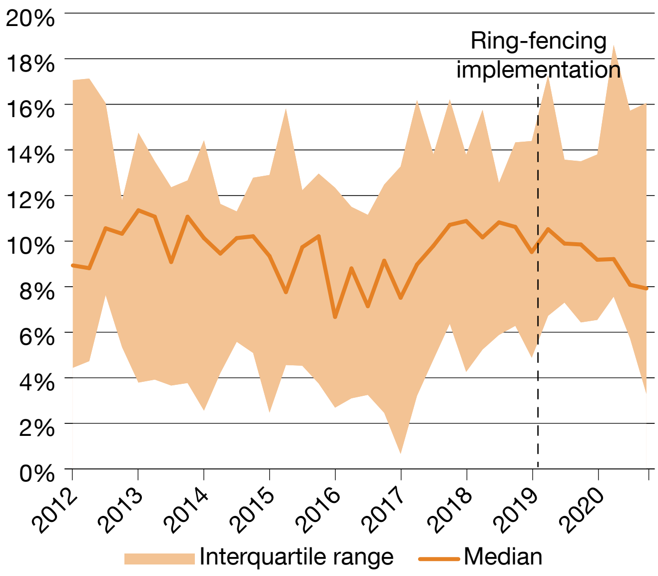


Figure 4.10: Proportion of competitor mortgages at high LTI[31]



Source: Submissions from Bank of England

30. *Single Income LTI > 4 or Joint Income LTI >3.*

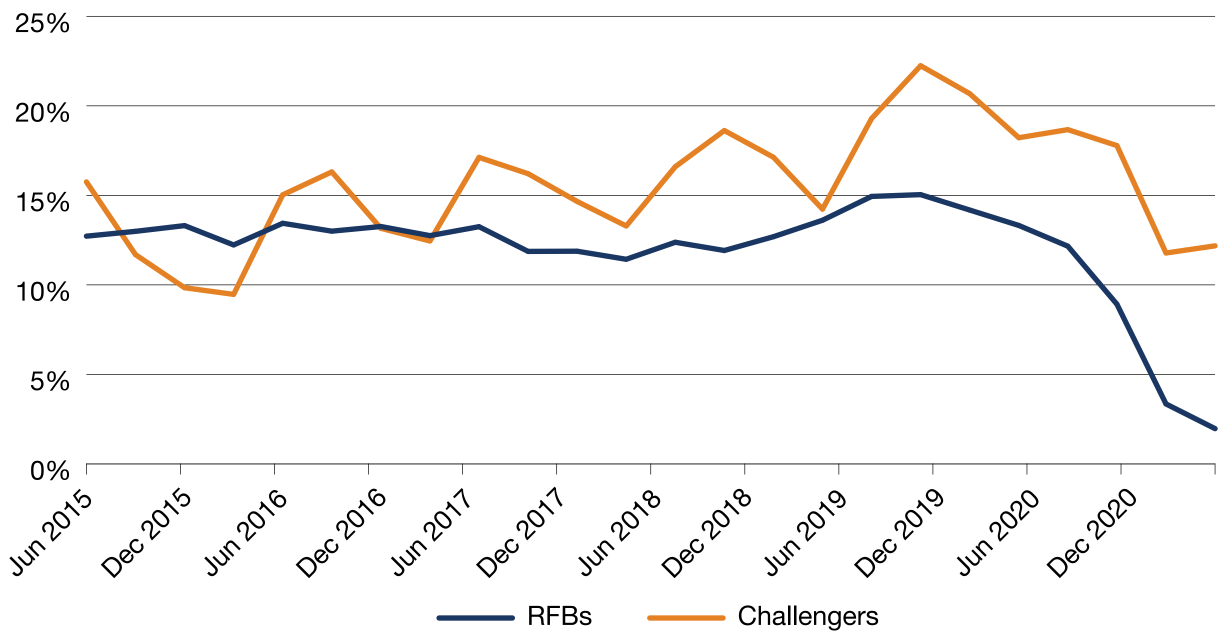
31. *Single Income LTI > 4 or Joint Income LTI >3, based on 12 competitor firms.*

4.57 Neither RFBs nor other lenders appear to have moved up the loan-to-income (LTI) risk curve (Figures 4.9 and 4.10).[32] This is likely to be a result of the FPC's mortgage market measure, which limits the share of new mortgages that can be issued at high LTI ratios.

4.58 As a proportion of new lending as shown in Figure 4.11, post ring-fencing RFBs have diverged from their competitors who have increased the proportion of lending to higher LTV customers, an indication of higher risk.

4.59 This may reflect the favourable capital weighting for low LTV mortgages from internal capital models used by RFBs, compared to standard models used by smaller banks, which is a significant driver for the composition of mortgage books.[33] The large drop for RFBs after 2020 illustrates the sharp reduction in risk appetite during the Covid-19 pandemic.

Figure 4.11: Proportion of new lending which is ≥90% LTV



Source: Submissions from FCA

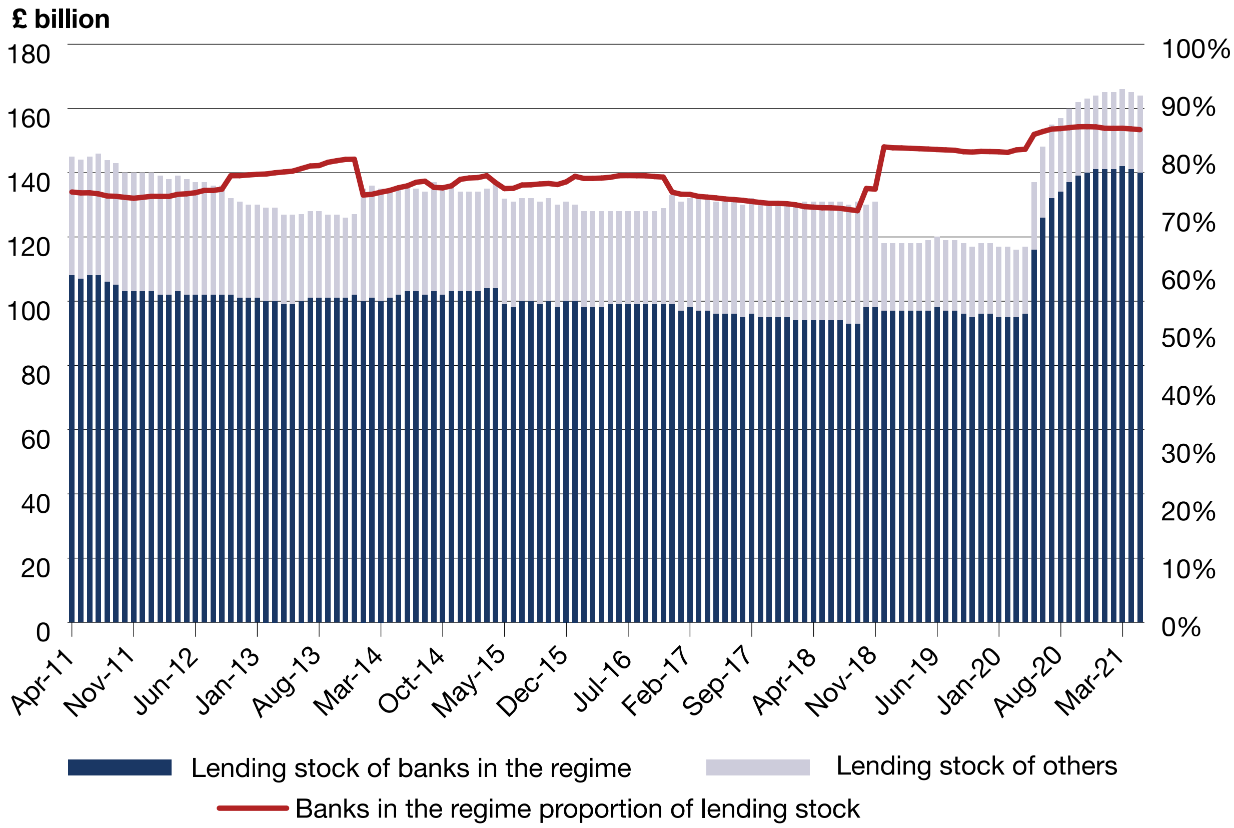
Corporate lending and productive finance

4.60 The impact of the ring-fencing regime on the provision of finance to the economy was also examined. **The evidence shows some marginal impacts on the provision of wholesale finance from banks in the regime, but overall there was no material impact in terms of credit supply or pricing for UK corporate and SME lending markets.**

4.61 Bank lending remained broadly flat in the run-up to ring-fencing and for the first 12 months after, as illustrated in Figure 4.12 and Figure 4.13. From 2020 onwards there has been an increase, but this is attributable to the Covid-19 pandemic as demand increased and various government schemes were launched.

32. *LTI compares the size of a mortgage to the borrower's income and is often used as a risk-indicator for mortgages.*
33. *Source: UK Finance response to the RFPT Review's call for evidence.*

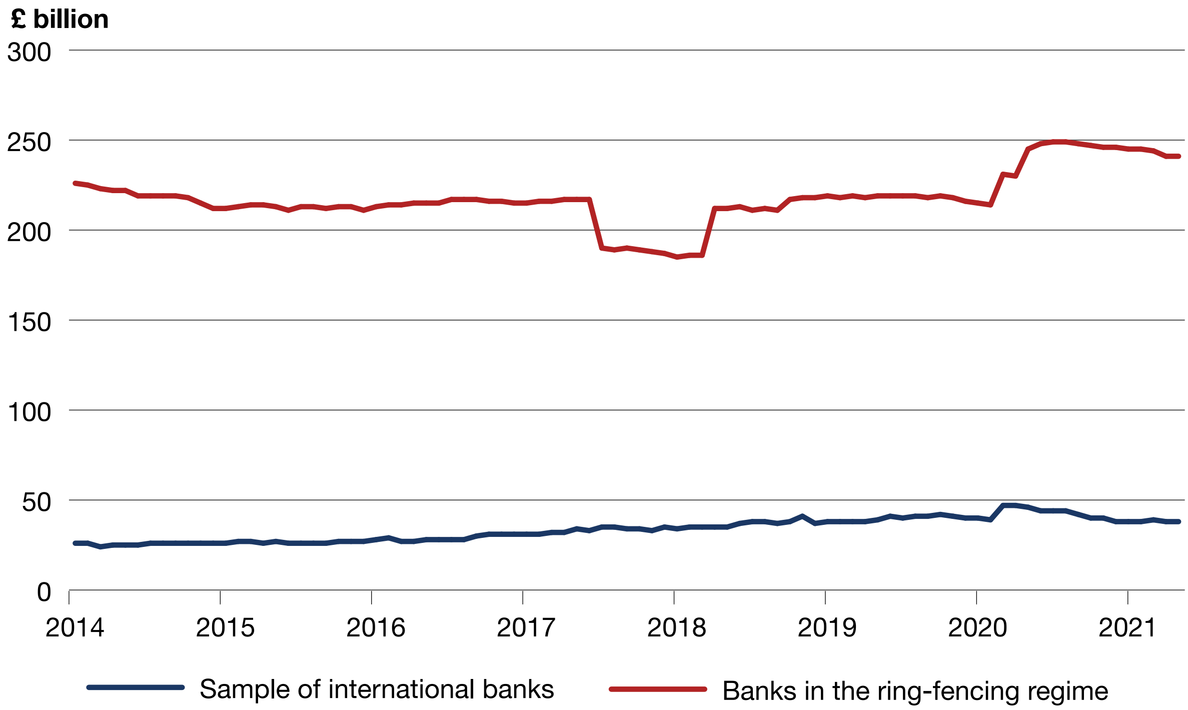
Figure 4.12: SME lending stock[34]



Source: Submissions from Bank of England

34. *Large step-changes attributed to sample changes and reclassifications. For example, a key SME lender being withdrawn from the reporting sample.*

Figure 4.13: Private non-financial corporates (PNFC) loan stock[35]

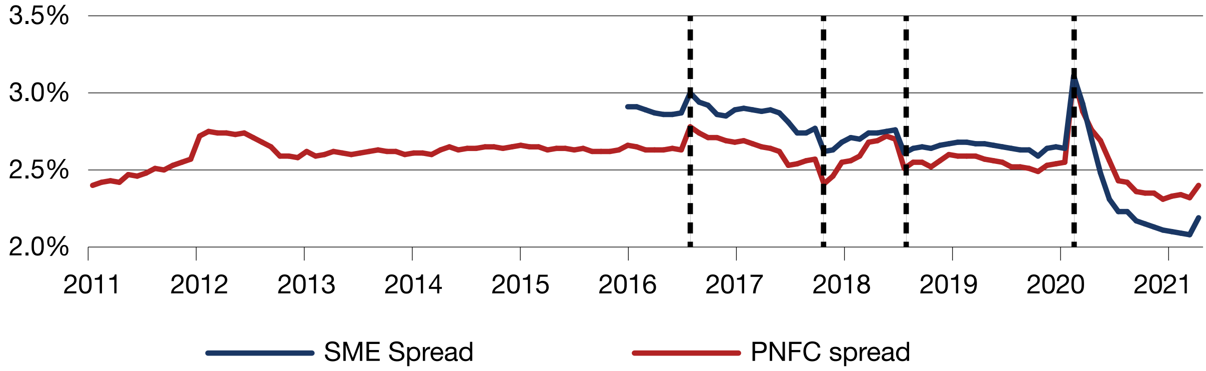


Source: Submissions from Bank of England

4.62 Banks in the ring-fencing regime saw a small fall in market share of overall corporate lending following the implementation of the regime, as indicated in Figure 4.13. During the same period, international banks continued to increase their market share. During the Covid-19 pandemic, this was reversed, and RFBs' loan stock is now at its highest point in seven years.

4.63 In terms of prices, effective rates on SME loans and wider corporate lending were constant pre-Covid-19, with no changes obviously attributable to ring-fencing (Figure 4.14).

Figure 4.14: SME and PNFC stock loan rate spreads[36]



Source: Submissions from Bank of England

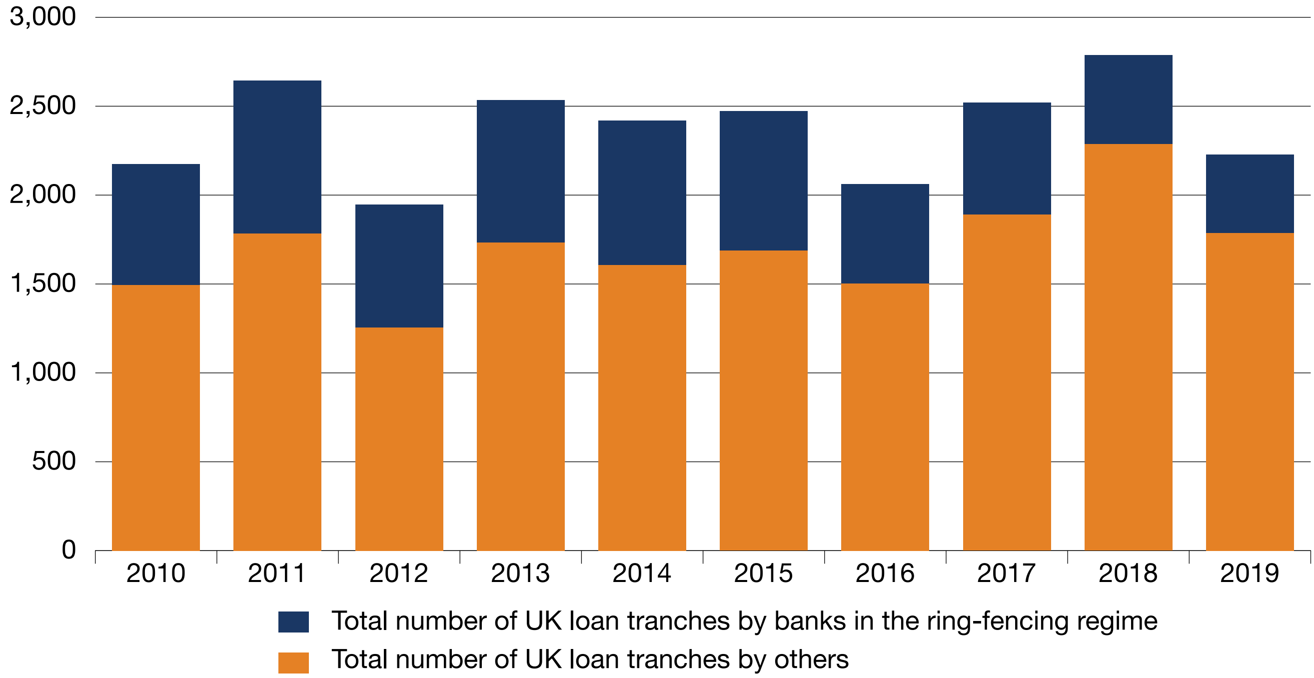
35. *Large step-changes attributed to sample changes and reclassifications.*

36. *Dotted lines mark changes in policy interest rates.*

4.64 A Bank of England staff working paper outlines that ring-fencing led to a fall in both the number of syndicated loans that NRFBs extend to international borrowers and the amount that they contribute to such loans.[37] The paper also shows a reduction in the number of loans to UK borrowers, but that was much smaller. Confidential evidence from the regulators suggests that UK firms did not in general obtain smaller loans when their loan syndicates included affected NRFBs.

4.65 This evidence could indicate that NRFBs have either chosen to reduce participation or been put at a competitive disadvantage in the syndicated lending market. Based on data from the Bank of England, as illustrated in Figure 4.15, the number of syndicated loans by NRFBs to UK borrowers has remained broadly stable over the observed timeframe.[38]

Figure 4.15: Syndicated lending to UK headquartered firms



Source: Submissions from Bank of England

4.66 Overall, the evidence shows that the total provision of syndicated lending finance to UK borrowers has fluctuated around the same level prior to, and since, the implementation of the ring-fencing regime.[39] Any reduction in the provision of syndicated loans to UK borrowers by NRFBs, was balanced by other banks being able to meet demand. Provided the market is competitive, which was acknowledged by firms during consultations, this suggests little or no customer detriment, but could indicate that there are potential issues for UK banks' competitiveness.[40]

Competitiveness of UK banks

4.67 **Most of the banks in the ring-fencing regime indicated that the regime has negatively impacted the competitiveness of UK NRFBs compared to their international peers.** As an example, UK Finance said that "the additional cost, complexity, and inefficiency of ring-fencing has added

37. *Bank of England, Staff Working Paper, 2020, Separating retail and investment banking: evidence from the UK.*
38. *The average length of syndicated loans is 6 years. Impacts from ring-fencing could be expected from 2013-2019.*
39. *The average length of syndicated loans is 6 years. Impacts from ring-fencing could be expected from 2013-2019.*
40. *UK Finance response to the RFPT Review's call for evidence.*

to the pressure on UK banks' returns on equity. This in turn constrains their ability to invest in innovation and improve customer service and, over the longer term, could undermine UK banking's attractiveness and competitiveness".

4.68 In reviewing the evidence on the competitiveness of UK banks, a range of areas were analysed, including funding costs, market share, and revenue. However, given the relatively short period since the introduction of ring-fencing, and the small number of banks affected, it is challenging to separate out the competitiveness impacts from other drivers.

Increased NRFB funding costs

4.69 Without access to the cheap deposit funding of RFBs, NRFBs need to raise more wholesale funding, which is more expensive. This in turn makes them less competitive than before ring-fencing. Instances of increased internal cost of funds indicate that NRFBs' funding costs have indeed risen, as predicted by the ICB. However, wider macroeconomic conditions such as the low Bank Rate and central bank liquidity in the form of quantitative easing (QE), appear to have minimised the impacts of this so far. Funding costs may become a more substantial issue in the future if these broader economic conditions change.

4.70 As noted, the ICB recognised this issue, and estimates were provided to Parliament at the time of the legislation being passed.[41] Therefore, while it does have an impact, it is not something that was unforeseen, and the Panel has taken the view that this was an accepted cost.

4.71 In addition, funding costs are just one of many factors that influence pricing and competition in banking. Therefore, whilst acknowledging that funding costs may have increased for NRFBs as a result of the ring-fencing regime, this is unlikely to directly correlate with less competitive offerings and loss of market share.

4.72 **However, there are clear examples where ring-fencing is placing other additional costs and constraints on banks that their competitors do not face, including administrative, governance, and customer onboarding costs.** These costs are explored in more detail in Chapter 5.

4.73 Banks claimed that in general the additional burden and frictions are borne by themselves rather than by their customers. It is acknowledged that the internalisation of costs will be a drag on banks' profitability. However, to date the scale of the impact in the short period since the regime was implemented is challenging to quantify.

Market share and revenue of NRFBs

4.74 **UK investment banks faced challenges in competing in global investment banking markets prior to the introduction of the ring-fencing regime**, and the strength and growth of US banks have been the prevailing characteristic of these markets. EU banks unaffected by the ring-fencing regime have seen slower growth in revenue than UK banks, as indicated by Figure 4.16.

4.75 UK banks' relative revenue growth has remained fairly constant since 2014. Whilst banks in the regime shifted away from investment banking activities after 2016 compared to banks outside the regime, on balance the Panel concluded that this shift could have at least in part been driven by factors unrelated to ring- fencing.[42]

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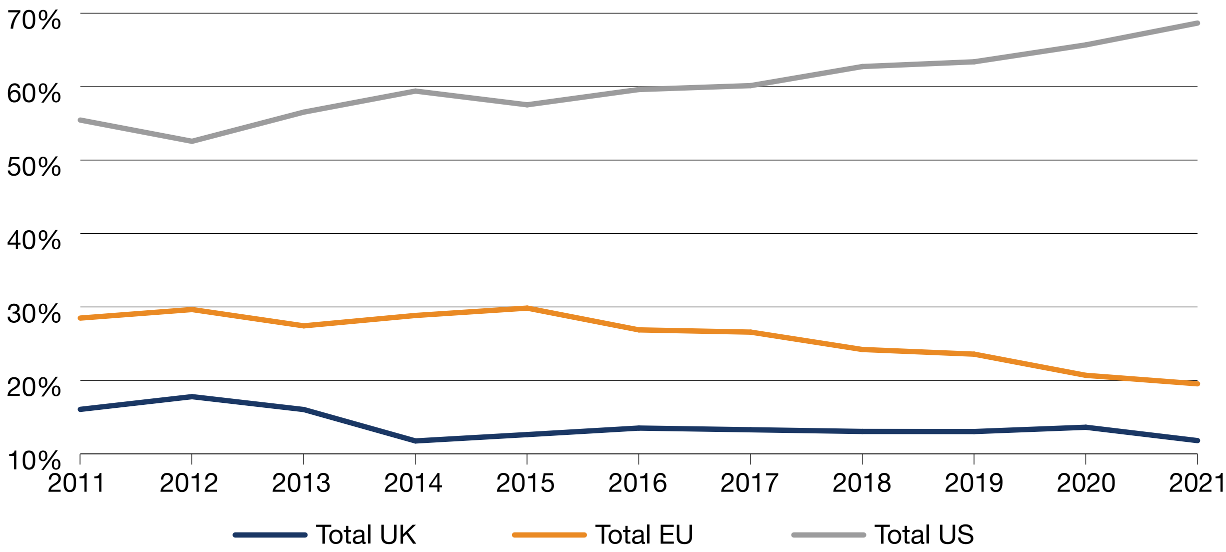
41. *HM Treasury, 2014, Banking Reform: Ring-fencing secondary legislation. Available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/336121/banking_reform_impact_assessment_05072014.pdf.*

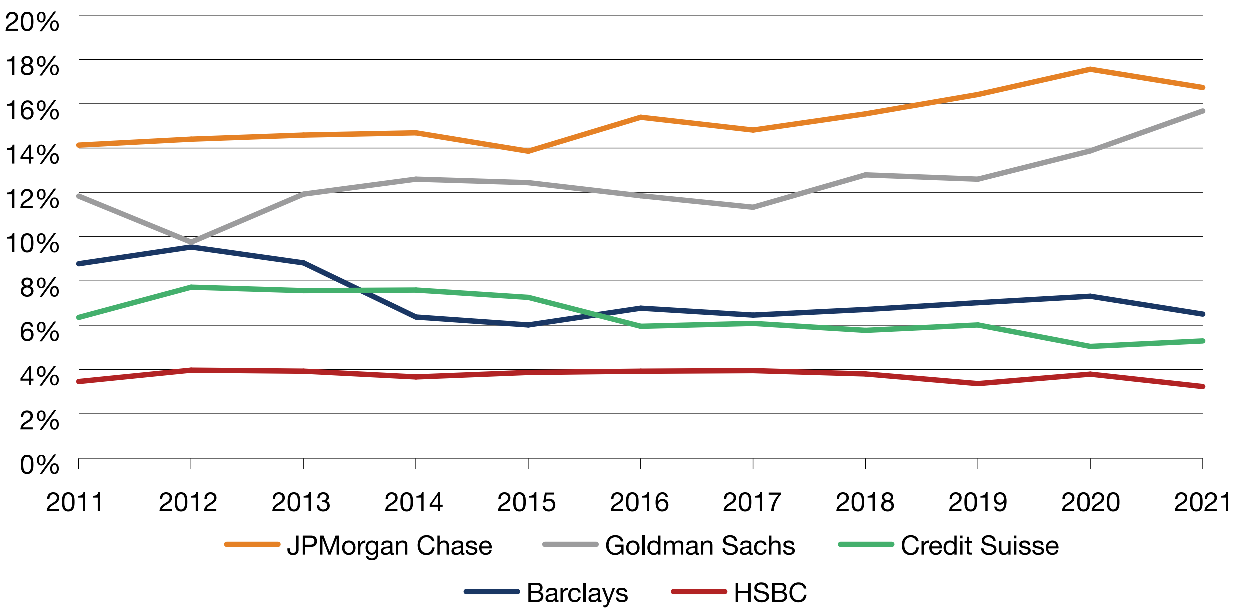
42. *Bank of England, Staff Working Paper, 2020, Separating retail and investment banking: evidence from the UK.*

Figure 4.16: Global revenue of investment banks[43]



Source: Submissions from Bank of England

Figure 4.17: Global revenue of investment banks[44]



Source: Submissions from Bank of England

4.76 Market shares and revenues of NRFBs could be driven by factors other than ring-fencing, such as the strategic decisions made by banks about expansion, investment, and closure of business lines. It is acknowledged that these decisions could have been driven by funding constraints or regime limitations. However, impact analysis during the Review was limited as only two of the UK banks

43. *Global fee revenue percentages are based on sample of 14 investment banks including 5 US investment banks, 5 EU investment banks, and 4 UK investment banks.*

44. *Global fee revenue percentages are based on a sample of investment banks that includes JPMorgan, Citigroup, Bank of America Merrill Lynch, Goldman Sachs, Morgan Stanley, Credit Suisse, UBS, Deutsche Bank, BNP Paribas, Societe Generale, NatWest (RBS), Barclays, HSBC, and Standard Chartered.*

within the ring-fencing regime had material global investment banking activities in their NRFBs that they were committed to maintaining or expanding. So overall the sample size and data set were very small and highly subject to idiosyncratic factors.

4.77 More broadly, based on a sample of global investment banking revenues of 14 firms, HSBC's and Barclays' investment banking revenue growth appear to have relatively diverged slightly in years prior to the Covid-19 pandemic, as illustrated in Figure 4.17.

Regulatory arbitrage in the UK banking sector

4.78 Several UK banking groups and building societies argued that the ability of international universal banks to use up to £25 billion of deposits to fund their investment banking divisions is a competitive distortion. This distortion potentially impacts the retail savings market, as discussed previously, but also potentially lowers the cost of funding for investment banks outside of the ring-fencing regime. This has created regulatory arbitrage but the amount utilised in this way is currently immaterial when compared to the balance sheets of NRFBs and is therefore unlikely to currently distort competition.

4.79 **While ring-fencing may over time have an adverse effect on the growth and competitiveness prospects of NRFBs, there is so far limited evidence of this having occurred.** Competitive impacts from ring-fencing, while existing, seem to be marginal to date, with wider market dynamics such as the dominance of US banks and banks' strategic decisions appearing to drive trends.

Conclusions

4.80 Ring-fencing has to date had some impacts on banking competition and competitiveness but has not been the main driver in any of these areas. However, this assessment is based on the available evidence in the lead up to, and the short three-year period since, the ring-fencing regime came into force. This has made it challenging in some areas to reach definitive conclusions. A longer timeframe may give a better indication of the impacts of the regime, in particular as key influencing factors impacting the banking sector, such as monetary policy, funding conditions or Covid-19-driven liquidity, may change in the future.

4.81 The evolving nature of the banking sector, markets, and the regulatory environment will likely continue to change over time. Developments such as advances in technology and competition from fintech companies and digital currencies will require UK banks to adapt. The Panel considers it important that retail banking in the UK does not ossify over time in a way that inhibits adaptability. In Chapter 7, the Panel makes recommendations to provide more flexibility for banks and regulators to adapt to changing circumstances, and to serve the evolving needs of customers and the UK economy, which are equally dynamic.

Chapter 5

Operation of the ring-fencing regime

Key Findings

- **Banks in the ring-fencing regime are not attempting to circumvent the ring-fencing regime. Anecdotal evidence suggests banks have been cautious in how they have interpreted the rules.**
- **The design and implementation of the ring-fencing regime has resulted in rigidity and cliff-edge effects that prevent a smoother and more efficient operation of the regime.**
- **The definition of, and prohibitions related to, Relevant Financial Institutions (RFI) are overly complex and burdensome resulting in unintended consequences and undesirable outcomes for banks and their customers.**
- **The geographic restriction on where RFBs can establish or maintain operations limits their ability to provide services to internationally active customers based in the UK and EEA.**
- **There are some legal provisions that are no longer necessary, creating unintended consequences.**
- **The ring-fencing regime's governance requirements reflect best practices in place elsewhere and are complementary to the Senior Managers and Certification Regime (SM&CR).**
- **Estimates of one-off costs associated with establishing the regime and the on-going operational costs are inconclusive but appear to be broadly in line with the ICB's and HM Treasury's initial expectations.**

5.1 The Terms of Reference require the Review to examine any unintended consequences of the ring-fencing regime and areas that may require further clarification. In addition, when the ring-fencing regime was being debated in Parliament, there was concern that banks may not comply with the regime and that it may need to be "electrified".[1] This chapter addresses these subjects, examines the regime's governance arrangements, and outlines the operational costs of the regime.

The ring-fencing regime's requirements

5.2 **Figure 5.1 provides a visual representation of the multiple layers in which the ring-fencing regime restricts banks undertaking certain activities.** Banks are within scope of the ring-fencing regime if they hold more than £25 billion core deposits (legend key 1). Once within the regime's scope, RFBs are ring-fenced (legend keys 2 & 3) from their NRFB as they are not allowed to carry out investment banking activities and must hold retail deposits.

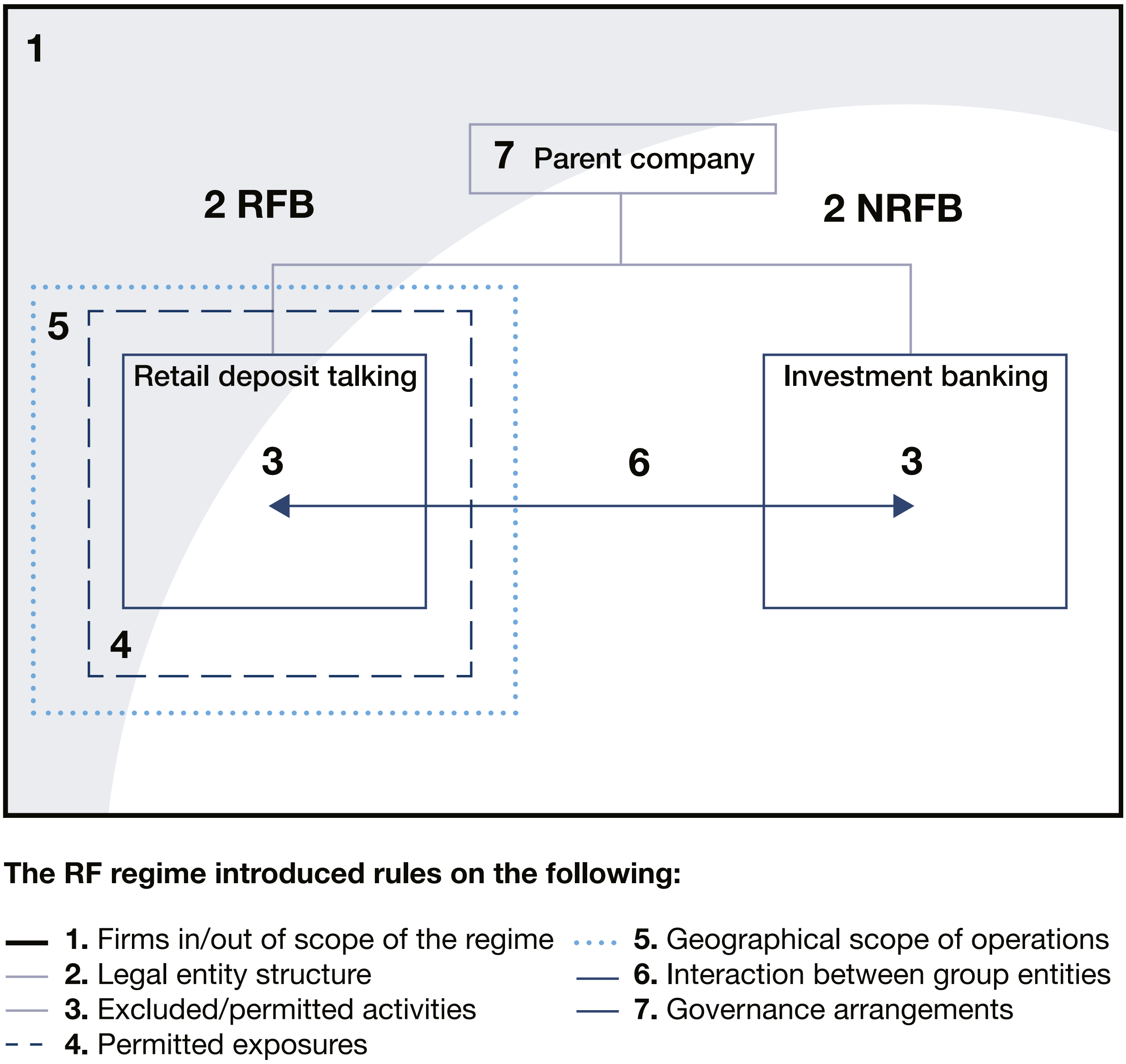
5.3 Further restrictions are placed on the types of customers that an RFB can have exposure to, including RFIs (legend key 4). A geographic ring-fence is placed around RFBs, limiting them to the European Economic Area (EEA) (legend key 5).

5.4 Limitations on how an RFB can interact with its NRFB (legend key 6). And finally, specific governance arrangements are in place such as a separate independent board for the RFB (legend key 7).

5.5 Most of these rules are in primary and secondary legislation, which means that the authorities are constrained in their ability to amend the rules where they may be justified by evolving circumstances.

1. *HM Treasury, 2013, Financial Services (Banking Reform) Bill, Briefing for Peers. Available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/245759/HoL_Policy_brief_-_Electrification_of_the_ring-fence.pdf.*

Figure 5.1: Key rules of the ring-fencing regime



5.6 The design of the ring-fencing regime created numerous cliff-edge effects through absolute restrictions in legislation that have led to some undesirable outcomes. Additionally, the original rationale behind some of the ring-fencing provisions is no longer applicable. This is discussed further in the chapter.

Compliance with the ring-fencing regime

5.7 One of the reasons that Parliament mandated a review into the ring-fencing regime following implementation was to assess whether banks were fully complying with the regime or if it needed to be 'electrified'. Electrifying the ring-fence means fully separating the RFB and NRFB of a bank, with each becoming separately owned banks. Regulators have restructuring powers that can be used to 'electrify' the ring-fence if a bank is found to be behaving in a way that undermines the objectives of the regime.

5.8 There has been no evidence of banks undermining the objectives of the ring-fence or "tunnelling under" it. The PRA has found that RFBs have complied with the regime except for a limited number of minor breaches.[2] Breaches in 2020 were "mostly of low materiality, and none were classed as severe".[3] In every case, banks resolved any breach immediately or implemented remediation plans. In the latest data available as of March 2021, the PRA had not taken any enforcement action against banks in relation to the ring-fencing regime.[4]

5.9 Additionally, anecdotal evidence suggests that banks have taken a cautious approach when implementing the regime. For example, RFBs are not allowed to have exposures to RFIs but can provide them with basic services such as current accounts. In general, banks have chosen to avoid having RFIs as customers in their RFBs, so as to not inadvertently breach ring-fencing restrictions. This is supported by confidential evidence submitted by the PRA that banks have in some cases a very low risk appetite for any breach, no matter how minor or inadvertent.

The constraints of the ring-fencing regime

5.10 RFBs are prohibited from carrying out certain activities, which in turn means that they cannot sell some types of financial products to their customers. An RFB is in breach of the ring-fencing rules if it carries out an excluded or prohibited activity regardless of its scale or value, as the restrictions are absolute and there is no ability for the authorities to exercise any discretion.

5.11 This has resulted in undesirable cliff-edge effects. RFBs face disproportionate compliance costs as they must monitor and report breaches of any size, even if immediately rectified. These types of immaterial breaches do not promote the objectives of, nor adherence to, the ring-fencing regime, as illustrated by the examples from industry responses during the Review in Box 5.1.

5.12 As a result, in some cases banks have taken commercial decisions to not provide some banking services to customers where they are not explicitly prohibited from doing so, as shown in Box 5.2. This is to avoid inadvertently breaking the rules and reduce compliance and reporting costs. This has impacted customers that straddle the banking services that are offered by RFBs and NRFBs. An example is also demonstrated in Box 5.1.

5.13 Evidence was submitted that the restrictions on a number of activities are too rigid leading to limitations for banks and their customers. Many of the issues cited relate to restrictions on dealing as principal in securities or providing customers with derivative products. Overall, the regime lacks proportionality, allowances, or a degree of flexibility for the authorities in their approach to enforcement. This has led to undesirable outcomes for customers.

2. *PRA, 2019, Annual Report 2018-19. Available at https://www.bankofengland.co.uk/prudential-regulation/publication/2019/pra-annual-report-2018-19; PRA, 2020, Annual Report 2019-20. Available at https://www.bankofengland.co.uk/prudential-regulation/publication/2020/pra-annual-report-2019-20; PRA, 2021, Annual Report 2020-21. Available at https://www.bankofengland.co.uk/prudential-regulation/publication/2021/june/pra-annual-report-2020-21.*
3. *PRA, 2021, Annual Report 2020-21.*
4. *PRA, 2021, Annual Report 2020-21.*

Box 5.1: Complexity and compliance

RFBs face complexity when servicing customers

RFBs face complexity when servicing customers. Where an RFB is servicing a corporate customer that requires a mixture of permitted and prohibited business, the RFB faces additional complexity. The customer also faces additional relationships with the different parts of a banking group that is subject to ring-fencing, which can be operationally burdensome.

Take an example of a customer of an RFB that operates internationally outside of the EEA. It therefore needs to use different currencies in different countries. While an RFB can provide some simple FX products to manage FX exposure, it cannot offer some more complex FX products that may be appropriate for the customer.

To facilitate this, the customer would need to be referred to an NRFB, which creates additional complexity for both the bank and the customer in undertaking transactions. The customer's products would be split across two entities (the RFB and NRFB), resulting in ongoing additional administrative costs for the customer.

This additional complexity and cost would incentivise customers to deal with banks outside of the ring-fencing regime, where the full range of services can be provided in one entity.

RFBs are required to monitor and report immaterial breaches

It is unclear if an RFB can act as an agent for a customer who wishes to invest in shares. In the event of a failed trade, an RFB would not be able to rectify the error as this is considered to be dealing as principal. The RFB would be in breach of the ring-fencing regime if it corrected the error and must monitor and report this type of activity if a breach were to occur. This is because there is no exemption or discretion for failed client trades.

Source: Call for Evidence submissions

Exposure to Relevant Financial Institutions

5.14 Under the ring-fencing regime, RFBs are prohibited by legislation from having any exposure to RFIs. In short, the definition of an RFI includes all banks (apart from other RFBs), investment firms, globally systemic insurers, and funds (Undertakings for Collective Investment in Transferable Securities and Alternative Investment Funds).[5]

5.15 **Submissions to the Review's Call for Evidence highlighted that the definition of, and prohibitions related to, RFIs in the ring-fencing regime are overly complex and burdensome, resulting in unintended consequences** as outlined in Box 5.2. The analysis that was undertaken further supports this. RFIs, like other corporates, require basic banking services. The constraints faced by RFBs related to RFIs were the most cited complaint by respondents to the Review's Call for Evidence.

5.16 The rationale behind prohibiting exposures to RFIs was to reduce financial interconnectedness and RFBs' exposure to shocks in the wider financial system that would undermine the objectives of the ring-fence.

5. *The FSMA (Excluded Activities and Prohibitions) Order 2014, Article 2.*

5.17 The financial institutions that were intended to be captured by the prohibition were "those which a) engage in financial intermediation and b) those which may be highly leveraged, have a high degree of maturity or liquidity mismatch, or have a high degree of financial interconnectedness".[6]

5.18 There are several issues regarding the restrictions on exposures to RFIs:

- NRFBs are not generally suited to provide services to small RFIs as their product offerings are suited to larger businesses. This is supported by evidence submitted during the Review by RFIs (see Box 5.2 for an illustration).
- There is no proportionality, flexibility, or regulatory discretion in the current rules as they are set in secondary legislation.
- RFBs are required to report to the PRA any exposure to an RFI, no matter how immaterial, as it amounts to a breach of the prohibition.
- The list of financial institutions captured by the RFI definition is broad, complex, difficult to apply in practice, and in some cases out of date.[7] It further captures firms that would not be considered high risk and were not intended to be captured based on the conditions set out by HM Treasury as noted above.
- In the scenario where a customer of an NRFB ceases to be an RFI, any deposits it holds with the bank are likely to be regarded as "core deposits" which can only be held by an RFB. Therefore, the NRFB will need to transfer the customer's deposits to an RFB. However, there is no grace period for the NRFB in this situation, which means that the banking group is immediately in breach. There is also a concern that this situation might result in the loss of banking services for customers.

Box 5.2: The cost of RFI restrictions

A small RFI's inability to access basic banking services

An existing customer of a bank in the ring-fencing regime was identified as an RFI in May 2021 by the bank's RFB. The bank admitted that it had made a mistake in not assigning the customer to its NRFB in 2017, as it had not realised that it was an RFI. As RFBs are not allowed to provide credit facilities to RFIs, they took a commercial decision to not bank any RFIs.

In addition, the NRFB implemented a size criteria for new customers, which this RFI was below. The bank noted that it undertook a 'grandfathering' exercise in 2017 by transferring existing customers to the NRFB as part of the implementation of the ring-fencing regime, but that was no longer an option that the NRFB was willing to provide. The customer was using the bank to hold the total tier 1 capital of the firm in a savings account of roughly £360,000, and so required confidence in the stability of the bank. The customer was given 60 days' notice to move the account.

Following receipt of the 60-days' notice, this customer engaged with a number of banks to open a savings account, including all those inside the ring-fencing regime, and roughly 20 banks outside of the ring-fencing regime. A combination of limited banking services and size requirements resulted in just two offers in principle: one from a private bank that was willing to provide a business account on condition that the owners' private banking relationship is also transferred to it; and another from an 'intermediary' deposit taker on condition of client referrals from the RFI customer. At the time of engagement with the Review, the RFI was considering these two options, neither of which it wanted to accept but it had no other options.

6. *HM Treasury, 2012, Banking reform: delivering stability and supporting a sustainable economy, page 19.*
7. *The current RFI classification for a 'Global Systemically Important Insurer' is defined through reference to a list published by the FSB. The FSB announced in 2020 that it was suspending maintenance of the list and in 2022 may decide to no longer maintain the list.*

RFBs face disproportionate costs from RFI prohibitions

RFBs are not allowed to hold exposures to RFIs meaning that they are required to determine whether a customer, or potential customer, is an RFI. The process for identifying RFIs is complex and operationally cumbersome with one RFB reporting that it reviews 22 regulatory registers in its automated classification tool. This tool reviews around 1.3 million customer records daily for RFI classification purposes. In addition, on average the RFB undertakes over 500 manual classification reviews each month (over 250 Full Time Equivalent hours).

As a result of these disproportionate costs, and as noted in the previous example, some RFBs have taken a commercial decision to not provide any banking services to any RFIs.

5.19 Exposures to relatively small RFIs can be managed sufficiently through other regulatory requirements, including stress testing, liquidity and capital requirements, and large exposure limits, many of which have been implemented or materially enhanced since the RFI prohibition was proposed.

5.20 **The Panel is of the view that the current RFI definition and exposure prohibition captures types of businesses whose failure would be unlikely to pose a threat to the financial stability of an RFB. Examples include high street independent financial advisors and mortgage brokers.**

5.21 A practical example of these issues is that some SMEs were unable to access Covid-19 government lending schemes via RFBs because they were classified as RFIs, despite minimal financial risk to RFBs as the loans were guaranteed by the government.

Excluded activities for RFBs

5.22 Stakeholders submitted evidence that the restrictions on excluded activities are inflexible and potentially give rise to unintended consequences. Excluded activities that RFBs are not allowed to engage in are set out in legislation. These activities include dealing in investments as principal, and commodities trading.

5.23 Dealing in investments as principal is a very broad category, and exemptions are provided for in legislation which allow for hedging activities and providing some simple derivative products to customers. Otherwise, the restrictions are almost absolute in these types of activities. Further submissions were received stating that the restrictions on dealing in investments as principal are too rigid. Examples are provided in Box 5.3, as well as in more detail in Annex B.

5.24 **The restriction on these activities means that RFBs cannot provide a range of financial products and services to their customers**. In most cases this does not cause a material problem. However, there are a group of business customers that would benefit from a wider range of product offerings in the RFB, especially where they are not sufficiently large enough (or profitable enough) to be banked by an NRFB. The result of this is inconvenience and undesirable outcomes for banks and their customers, and in some cases these restrictions do not improve financial stability.

Box 5.3: Restrictions on the provision of financial services to businesses

RFBs face complexity when providing product packages to customers

A mid-sized corporate customer of an RFB drew a loan based on the movement of a 3-month LIBOR rate with an embedded floor (floors are the lowest possible rate for a loan that has a variable rate). The customer wanted to hedge and took out an interest rate swap to mitigate against an overall interest cost increase should LIBOR fall below zero. The customer also wanted to buy a floor. The RFB could not service this, as it is a prohibited product under the current regime. The floor was therefore provided by the NRFB, complicating the customer's hedging strategy.

RFBs are limited in their ability to support companies through investments

RFBs are limited in their ability to invest directly in companies, through equity investments, to the detriment of both real economy participants and RFBs. This is because RFBs are prohibited from dealing in investments as principal (subject to exemptions).

The minor exceptions available for the holding of equity investment do not address the reality of what is required for the ongoing daily operation of an RFB. To ensure the RFB remains compliant with the legislation, detailed legal analysis and regulatory engagement is required in some cases to enable the RFB to hold participating interests. For example, an RFB's interest in the Business Banking Resolution Service was a complex issue for the industry to resolve despite the clear customer benefits.

RFBs can be subject to undesirable outcomes when carrying out distressed corporate restructuring

A UK retailer was severely impacted by the Covid-19 pandemic and had no access to government lending schemes. The company also required liquidity to maintain the business as a going concern.

An RFB converted an existing loan to the retailer into equity. However, due to ring-fencing requirements, and as no debt was written off as part of the restructure, the RFB was prohibited from holding the equity stake. Another part of the RFB's group agreed to acquire the shares. While a solution was found on this occasion, it is unclear that it would work in every future scenario and some banking groups may not even have the option to sell an equity stake to a different part of their group.

Operational outcomes from the ring-fencing regime

5.25 The Review received submissions that specific legal provisions were complex and difficult to apply in practice, and in some cases have had negative outcomes. In addition to the issues discussed in this chapter, the Report sets out the wider list of technical issues raised by stakeholders in Annex B, Sections 3 and 4.

Mergers & acquisitions for banks in the regime

5.26 **The ring-fencing regime constrains an RFB from acquiring a deposit-taking business that currently sits outside the ring-fence.**

5.27 If a bank crosses the £25 billion threshold and becomes subject to the ring-fencing regime, the bank is allowed a four-year transition period to comply with the ring-fencing requirements. However, there is no transition period in the scenario where an RFB merges with or acquires a bank that is not subject to the ring-fencing regime.

5.28 Post-transaction, the acquired business would be immediately subject to ring-fencing and required to comply with all ring-fencing requirements. This is not practical or feasible and is inconsistent with the four-year transition period given to banks that cross the £25 billion threshold through organic growth.

5.29 This creates a particular concern in stress scenarios where a private sector purchaser is sought to rescue a distressed bank before it enters resolution. If RFBs cannot act as the acquirer, out of concern for breaching the ring-fencing requirements, this would significantly reduce the pool of potential acquirers. Eliminating from that pool the largest banking groups that would probably be the most likely candidates to take on a failing bank, potentially limits the options available to the authorities in a stress scenario.

NRFBs' ability to service central banks

5.30 Under the ring-fencing regime, the starting point is that the activity of "accepting deposits" must be carried out by an RFB and not by an NRFB. There are certain types of customers whose money deposited with a bank are not regarded as deposits – which means that they can be serviced by an NRFB. That list of customers includes the Bank of England, other regulated banks, and various international development banks. Prior to the EU leaving the UK, the list had included central banks of other countries, but during the process of onshoring EU legislation they were removed from that list. The consequence of this is that other central banks must now be serviced by an RFB and cannot bank with an NRFB.

5.31 Central banks are, in their nature, very different to the types of customer that an RFB would normally expect to be servicing and would be likely to have needs that an RFB is not allowed to service (due to the restrictions on the other activities that an RFB can undertake). This may mean that RFBs are unwilling to accept central banks as clients. It is not apparent why NRFBs should not be allowed to provide central banks with all the banking services that they require. This is a potential unintended consequence caused by the onshoring of EU legislation.

The status of trustees and insolvency practitioners is unclear

5.32 The ring-fencing regime generally provides that deposit accounts for individuals (other than certain high-net-worth individuals) should be held by an RFB. However, there are some instances where that approach may not be appropriate:

- **Insolvency practitioners:** Insolvency practitioners are individuals (which would ordinarily mean that they must be banked with an RFB) that may require banking services in their capacity as insolvency practitioners. When a company that banks with an NRFB becomes insolvent, the insolvency practitioners would normally operate accounts with that NRFB too. This can lead to an insolvency practitioner needing separate accounts with an RFB and the NRFB in respect of the same insolvency arrangement.
- **Trustees:** Trustees are often individuals, even in relation to relatively large and sophisticated trusts such as occupational pension schemes. However, as they are individuals, it is unclear whether they can be regarded as qualifying "organisations", particularly given the fact that it is usually the trustees who hold legal title to the trust's assets.

The Notice of Declaration (NoD) onboarding requirement for NRFB customers

5.33 If an NRFB wishes to take on a new customer, it is required to first collect a set of information from that customer. Following that, the NRFB must provide the customer with an NoD notifying them that they meet the qualifying conditions to be banked by the NRFB and why the NRFB has made that decision. Within 14 days of receipt of the NoD, the customer can submit reasons why it believes the NRFB's decision is a mistake.

5.34 The primary purpose of the NoD was to facilitate the effective separation of RFBs and NRFBs by 2019, given the large volume of customers that needed to be moved. Now that separation has been completed, this requirement appears redundant.

5.35 The requirement for NRFBs to issue an NoD to its clients unreasonably lengthens the onboarding process and it is not apparent how this practice supports the ring-fencing regime or financial stability objectives. The NoD requirement impairs the client experience when compared to non-UK banks that do not have to issue NoDs.

RFBs' geographical restrictions

5.36 RFBs are not allowed to open a branch or subsidiary outside the UK or EEA.[8] The government's key concern and rationale behind the introduction of the geographical restriction was the barriers to resolution that the branches and subsidiaries of UK banks could create. The government acknowledged that arrangements could be made bilaterally to allow for RFBs to maintain subsidiaries or branches in non-EEA jurisdictions where cross-border resolution agreements emerge between the UK and other jurisdictions.

5.37 The government acknowledged that this restriction could be eased in the future provided that cross-border resolution agreements with non-EEA countries' authorities were satisfactory for the UK resolution authority.[9]

5.38 When the prohibition was introduced, EU law prevented the geographical restriction from being applied to EEA member states. While it would now be legally possible for the restriction to be narrowed from the EEA to the UK, a tightening of restrictions is unlikely to improve the effectiveness of the ring-fencing regime. Yet, retaining the EEA as the geographical scope of the regime seems anachronistic. Indeed, it is not clear that banking in EEA jurisdictions is necessarily less risky than in many non-EEA jurisdictions.

5.39 **Similar to the absolute restrictions on some excluded activities, there are several problems caused by the current geographical restriction being set out in legislation.** While the rule does not explicitly prohibit an RFB from providing services to customers that are based outside the UK/EEA (as long as the customers are serviced from the UK/EEA), it is impractical. It limits RFBs' ability to service their UK customers outside the EEA, as illustrated in Box 5.4, and hampers the facilitation of international trade.

Box 5.4: Geographic restrictions limit RFBs' ability to service customers

RFBs are unable to provide basic products

Due to current restrictions RFBs are unable to access various markets for liquidity management purposes, notably the US dollar market. RFBs are unable to have a US branch that they could manage to London hours, which effectively means they have shorter operating hours across time zones and therefore cannot access US dollar liquidity later in the day.

The limited ability for RFBs to offer a comprehensive US dollar payment service to its customers puts RFBs at a disadvantage. There have been multiple instances where an RFB was unable to offer a customer a secured credit facility due to its inability to access short-term dollar funding.

Source: Call for Evidence submissions

5.40 The resolution framework for banks has evolved significantly since this concern prompted the blanket prohibition on non-EEA activities. Banks must already consider their overseas activities

8. *FSMA (Excluded Activities and Prohibitions) Order 2014, Article 20.*
9. *HM Treasury, 2012, Banking reform: delivering stability and supporting a sustainable economy.*

when developing resolution plans and some regulators have cross-border resolution agreements in place. The home regulator, where the bank is headquartered, may have an agreement with the host regulator where a bank has a branch or subsidiary. Where that is the case, and resolution plans are in place, the original rationale behind the restriction no longer applies.

5.41 **Furthermore, the blanket non-EEA geographic prohibition is redundant.** If a UK bank wished to establish a branch or subsidiary in a third country, it would need to notify the PRA in advance if it is considered a material change. Banks are required to notify the PRA of any business expansion, such as setting up a new undertaking within its group or a new branch (whether in the UK or not), which could have a significant impact on its risk profile or resources. The new branch or subsidiary would also require authorisation in the third country, and the local regulators responsible for granting that authorisation would likely liaise with the PRA while considering the application.

5.42 Where a bank notifies the PRA of a proposed expansion, the PRA can under its current powers seek the bank's assessment of the risks and impact on resources. This could include describing the governance and management structure for the new entity, providing financial projections, explaining the risk profile of the branch's activities, ways in which risks are managed, mitigated and reported, and potentially updating the bank's business plan.

5.43 The PRA supervisory approach will also depend on whether a bank is seeking to open a branch or subsidiary in a third country. A branch is part of the same legal entity as the bank, meaning that the capital and liquidity position of the bank would need to take into account the branch's activities. The PRA could require the bank to hold more capital and liquidity.

5.44 A subsidiary is a stand-alone legal entity in a third country which would be subject to the same rules on governance, risk management, and capital and liquidity requirements as banks headquartered in that country. As the subsidiary has its own financial resources and is self-sufficient, in most circumstances it should not place any direct strain on the UK bank. In any event, the position of a subsidiary is considered in, for example, stress testing, evaluation of group risk, and recovery and resolution planning. Home and host supervisors would consider these issues and a bank's plans in their supervisory review processes including in supervisory colleges or other bilateral discussions.

5.45 Overall, the PRA has developed sufficient oversight and supervisory tools to manage risks arising from an RFB opening a branch or subsidiary in a third country.

Governance of banking groups in the regime

5.46 The independence of RFBs was a key element of the ICB's recommendations. RFBs are required to operate independently of their group and are subject to requirements regarding Board composition, committees, remuneration, risk management, internal audit resources and conflicts.

5.47 Stakeholders provided submissions that the ring-fencing regime's governance requirements are overly complex, burdensome, create legal conflicts, and go beyond what is necessary to support the independence of RFBs. The issues were carefully considered and assessed during the Review.

The independence of RFBs

5.48 Stakeholders raised concerns that certain corporate law rules prevent an RFB from acting independently from its parent or wider group, thereby creating a conflict with ring-fencing governance requirements.

5.49 In particular, a Board is required to act in the interests of the company, which normally means the interests of shareholders. A Board should normally act on the instructions from shareholders. At the same time, banks are required to act in accordance with applicable laws. For example, UK regulated financial institutions are subject to rules including an obligation to 'treat customers fairly'.

5.50 The PRA has made clear in its guidance that it expects accountability to parent shareholders to continue to be the baseline for RFBs, but that it also expects RFBs to deviate from shareholder instructions where necessary to comply with ring-fencing requirements.[10]

5.51 **There does not seem to be a conflict between the duties to a shareholder and obligations to comply with the ring-fencing regime's regulations.** There would only be a conflict if a shareholder directed the Board to act in breach of ring-fencing regulations, which would be similar, for example to a scenario where shareholders directed a Board not to comply with consumer protection laws.

5.52 It is difficult to argue that acting in breach of legal requirements is in the best interests of the RFB or the wider group. Not only might the bank incur fines, compensation claims and reputational damage, but it could ultimately lose its PRA authorisation and be unable to continue doing business. In almost all situations, compliance will be consistent with the interests of the wider banking group.

5.53 Some stakeholders also expressed views that there are practical difficulties in balancing independent decision making with the need to support its parent shareholder given that the RFB remains dependent on decisions taken outside of the RFB.

5.54 However, the PRA has made clear that RFBs are not expected to be independent in all respects. RFBs are expected to comply with parent instructions, except where those instructions have the potential to lead to a breach of the ring-fencing rules.

The ring-fencing regime's governance requirements

5.55 Some stakeholders indicated that the ring-fencing regime's governance requirements were stricter than other governance rules, burdensome, and disproportionate. The ring-fencing regime's governance was compared to other governance rules, which is set out in detail in Annex C.

5.56 **In most cases the ring-fencing rules replicate, rather than go beyond, existing guidance or best practice.** For example, Section 2, provision 11 of the UK Corporate Governance Code states that "at least half the Board, excluding the chair, should be non-executive directors whom the Board considers to be independent". The requirements under the ring-fencing rules mirror this requirement.

5.57 It was considered whether this type of duplication was necessary. If the ring-fencing rules were removed, RFBs would only be subject to PRA and Companies Act (CA 2006) governance rules, which do not contain requirements on Board composition, and general PRA guidance on corporate governance. The PRA would not be able to take enforcement action in respect of breaches of guidance.

5.58 The ring-fencing rules are simply an application of existing best practice. There is merit in these requirements remaining 'codified' in the PRA Rulebook. This allows the PRA to take appropriate action for breaches where necessary.

5.59 Some stakeholders argued that the ring-fencing governance requirements are disproportionate, particularly where there is a high degree of alignment between the RFB and the group. The PRA is

10. *Bank of England, 2015, Policy Statement 10/15, pages 6-7.*

able to (and has) issued a number of waivers in relation to the governance of RFBs, where the rules have been determined to be "unduly burdensome" or where they do not achieve the purposes of ring-fencing.

5.60 The interaction between the ring-fencing regime's governance requirements and the SM&CR was further considered. The objectives of the SM&CR focus on the responsibility of individuals, whereas the ring-fencing regime applies primarily to the RFB itself. The Panel concluded that the two regimes are complementary.

5.61 The SM&CR imposes obligations and responsibilities upon certain senior individuals within an RFB. The SM&CR holds individuals to account for ensuring that the business of the RFB for which they are responsible is controlled effectively and in accordance with relevant regulations.

5.62 In contrast, the governance requirements of the ring-fencing regime have a legal entity focus, i.e. establishing and maintaining a ring-fence around certain banks and ensuring that those banks take independent decisions to the extent required. The SM&CR permits enforcement against individuals while the ring-fencing regime permits enforcement against legal entities.

5.63 **Overall, the Panel concluded that the ring-fencing regime's governance requirements reflect best practice of regimes in place elsewhere.** Furthermore, the PRA has sufficient flexibility to modify the rules for individual banks on a case-by-case basis and has actively granted such waivers. Further analysis on the governance requirements can be found in Annex C.

Costs of the ring-fencing regime

5.64 The implementation and ongoing costs for banks arising from setting up and complying with the ring-fencing regime were analysed to see if they were in line with the original expectations of the ICB and HM Treasury.

5.65 The ring-fencing regime imposed direct costs on banks including set-up and ongoing compliance costs, as well as increases to the cost of capital and funding costs, as set out in Chapter 4. This was expected and acknowledged by the ICB in its report in 2011. "…*the cost of capital and funding for banks might increase. But insofar as this resulted from separation curtailing the implicit subsidy caused by the prospect of taxpayer support in the event of trouble, that would not be a cost to the economy. Rather, it would be a consequence of risk returning to where it should be – with bank investors, not taxpayers – and so would reflect the aim of removing government support and risk to the public finances."*

5.66 Many of the costs of the regime were difficult for banks to attribute and quantify during the Review for a number of reasons, including some costs being absorbed as business as usual or being costly to measure**. Consequently, the summary of costs across banks in the regime is only indicative.**

Implementation costs

5.67 Based on banks' submissions, implementing the ring-fencing regime had a one-off cost for the industry of c. £2.9 billion**.** HM Treasury's estimated that the implementation costs would be between £0.5 - 3 billion.[11]

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11. *HM Treasury, 2014, Impact Assessment, Banking Reform: Ring-fencing secondary legislation, page 24. Available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/336121/banking_reform_impact_assessment_05072014.pdf.*

Ongoing costs

5.68 Banks submitted information on ongoing costs in two broad categories – operational costs, and other costs that included loss of profit from reduced business opportunities; capital, liquidity and balance sheet limitations; and collateral and hedging inefficiencies. Due to the variation in types and scale of these costs and the subjective nature of some items, it has not been possible to draw a strong conclusion based on aggregating these costs.

5.69 While noting the caveats, based on estimates provided by banks in the ring-fencing regime, the annual aggregate ongoing cost for banks is £1.5 billion, broken down as £0.5 billion for operational costs, and £1 billion for other ongoing costs. HM Treasury estimated that the total ongoing costs would be between £1.8 - 3.9 billion.[12]

Conclusions

5.70 **The design of the ring-fencing regime has created barriers for banks in providing core banking services to customers.** This is as a result of absolute restrictions set out in legislation, and the subsequent decisions of banks to reduce their service offerings based on the related compliance requirements and commercial viability.

5.71 While some restrictions are in force to improve the resilience of banks, some blanket restrictions and redundant provisions are unnecessary from a financial stability perspective and freeze out some categories of customers. Overall, there is a need to introduce flexibility for regulators and banks to make the regime simpler to operate and provide customers with the banking services they need.

5.72 Chapter 7 sets out the recommendations aimed at addressing the immediate issues faced by customers. The recommendations further aim to create some flexibility for the authorities to manage changes in the future without the need for additional legislative changes or programmes. In these proposals, the Panel seeks to maintain the financial stability benefits of the regime.

12. *HM Treasury, 2014, Impact Assessment, Banking Reform: Ring-fencing secondary legislation, page 24.*

PART II: PROPRIETARY TRADING REVIEW

Chapter 6

Proprietary trading

Key Findings

- **'Classic' proprietary trading is not undertaken to any significant extent by banks in the UK. This has been attributed to post-crisis reforms including increased capital requirements, the inception of the Senior Managers and Certification Regime (SM&CR), as well as restrictions in other jurisdictions.**
- **'Classic' proprietary trading activity is undertaken in the non-bank sector, often in hedge funds and principal trading firms that specialise in high-frequency trading.**
- **Direct risks from proprietary trading in banks are therefore reduced, however indirect risks from prime brokerage lending to the non-bank sector can contribute to systemic risks and therefore should continue to be monitored.**

Proprietary trading background

6.1 **'Classic' proprietary trading is where a firm uses its own money to trade in financial instruments, speculating on future prices to make a profit.** It is usually done on a short-term basis.

6.2 In extreme, the concern is that this type of activity could give rise to banks losing large amounts of money by effectively betting on price movements that turn out to be wrong. This in turn could give rise to risks to the safety and soundness of a bank and by extension, financial stability and the wider economy.

6.3 Following the GFC, some commentators viewed 'classic' proprietary trading activity by banks as being the cause of the crisis and often referred to it as "casino banking". In the context of such debates, Parliament took the view at the time that there should be strong restrictions on proprietary trading within RFBs, but that there was insufficient evidence to justify imposing a complete ban on this activity for all banks.

6.4 The FSBRA 2013 defines proprietary trading as taking place "where the person trades in commodities or financial instruments as principal." This covers a wider range of activities than just 'classic' proprietary trading and includes market making, trading on behalf of clients, and hedging activities.

6.5 The PRA was required by statute to review the case for restrictions on proprietary trading. It published its findings in September 2020.[1] The scope of this Review is to consider proprietary trading engaged in by banks. This Review assesses the conclusions of the PRA report and considers whether any further restrictions are necessary.

6.6 This Report covers the broad definition of proprietary trading but primarily focuses on the question of 'classic' proprietary trading in banks. There is also some consideration of related activities that are undertaken in the non-bank sector given the evolution of proprietary trading over the last decade.

1. *PRA, 2020, Proprietary Trading Review. Available at https://www.bankofengland.co.uk/prudential-regulation/publication/2020/proprietary-trading-review.*

Approach to proprietary trading restrictions in the UK

6.7 The Independent Commission on Banking (ICB) set out its assessment of proprietary trading activities as part of its review in 2011. The ICB noted that prior to the collapse of RBS in 2008, it had suffered large losses from proprietary trading.[2] The ICB concluded that those trading activities that are prohibited under regulatory restrictions in the United States - mainly under the Volcker Rule – should also be prohibited for RFBs.

6.8 The Parliamentary Commission on Banking Standards (PCBS) also reviewed the risks of proprietary trading in 2013 and raised concerns about the potential risks. However, its conclusions noted the practical difficulties in enforcing outright bans on proprietary trading given the difficulty in defining it, and so did not propose going further than the recommendations of the ICB to ban it from RFBs.[3] As a result, the FSBRA included a prohibition for RFBs against 'dealing in investments as principal'.

6.9 However, the PCBS remained concerned about proprietary trading. To address this, the FSBRA required the PRA to review its regulatory and supervisory approach two years after the implementation of the ring-fencing regime to establish whether there is a case for additional restrictions on proprietary trading. Finally, the FSBRA also mandated a review to be carried out by a panel of independent experts to assess whether further restrictions on proprietary trading were required, and whether it agreed with the conclusions of the PRA.

6.10 **The restrictions on proprietary trading in the UK are therefore limited to RFBs.** NRFBs within the ring-fencing regime, as well as banks outside of the ring-fencing regime, are not restricted from engaging in proprietary trading. Other jurisdictions took different approaches, which is discussed further.

6.11 **The PRA review into proprietary trading in 2020 concluded that the PRA does not require new powers to address the risks of proprietary trading and that further restrictions would not support PRA objectives.**

Approach to proprietary trading restrictions in other jurisdictions

6.12 Other jurisdictions followed different paths in mitigating proprietary trading risks, with varying degrees of prohibition.

6.13 **France** adopted a set of proposals limiting deposit-taking banks from proprietary trading and requiring banks whose trading book activities exceed a certain threshold to place all proprietary trading, market-making, hedge fund investments and other trading activities into independent, separate legal subsidiaries. All such entities have since been wound down due to poor performance caused by costs, lack of competitiveness from inefficiencies of scale, and the absence of credit quality given by the deposit-taking arm.

6.14 **Germany's** approach is similar to France's, with German banks above a certain threshold prohibited from conducting classic proprietary trading but allowed to undertake activities such as hedging. German banks are allowed to undertake classic proprietary trading in a separate subsidiary, but none have done so.

6.15 **Belgium** introduced a ban on some proprietary trading by banks in 2014 but with a number of exemptions, including trading for clients, market making, trading for a bank's own investment

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2. *ICB, September 2011, Final Report, page 33.*
3. *PCBS, 2013, Proprietary Trading. Available at https://publications.parliament.uk/pa/jt201213/jtselect/jtpcbs/138/138.pdf.*

portfolio, trading to manage liquidity, and asset and liability management. These permitted activities are then subject to additional qualitative and quantitative restrictions which include capital surcharges.

6.16 The **US** response, embodied in the Volcker rule, bans short term proprietary trading of certain financial instruments. The Volcker rule narrows its focus on classic proprietary trading and only for short term investments of less than 60 days. It also provides exemptions for other types of proprietary trading such as market making and hedging activities.

6.17 **Similar to the UK approach, other jurisdictions have aimed to separate different forms of proprietary trading from the core operations of their banks.** While the UK has relied on the ring-fencing regime to separate a broad range of activities from retail operations, other jurisdictions have isolated specific proprietary trading activities from their core operations. The precise mechanisms for doing this vary but the approach of other jurisdictions is stricter in some respects than the UK in that classic proprietary trading would not be permitted in an NRFB type entity if it were in France, Germany, Belgium, or the US given the importance of the NRFB.

Proprietary trading in banks in the UK, risk structures and mitigation functions

6.18 **Based on reviewing the regulatory returns of the main banks in the UK provided to the PRA, the Panel is satisfied that 'classic' proprietary trading is not undertaken to any significant extent by banks operating in the UK.** Due to confidentiality restrictions, it is not possible to publish or share details of the regulatory returns.

6.19 Other trading and proprietary trading activities continue, albeit with lower associated market risk than in 2010, as illustrated by Figure 6.1. However, the overall size of banks' trading books remains large, as shown in Figure 6.2. The reduction in market risk coincides with introductions relating to increased capital requirements for market risk in 2011, as outlined in Box 6.1.

6.20 The PRA outlined in its report the associated risks and potential losses from having large trading positions, even those related to hedging risks and managing liquidity rather than 'classic' proprietary trading. However, the PRA also recognised the associated benefits in hedging risks. The Panel takes a similar view of the associated risks, in particular when it relates to hedging and liquidity management as these are necessary functions to facilitate the day-to-day operations of a bank or hedging services for client facilitation.

6.21 In considering the risk structures and mitigation functions that banks have in place, the banks' regulatory returns to the PRA were analysed. While these returns remain confidential, the Panel concluded that the risk structures and mitigation functions were comprehensive.

Box 6.1: Basel and the development of capital requirements for market risk

Post-GFC saw a shift in regulatory focus towards global implications of banking activities and interconnections between banks. The introduction of tighter capital requirements through Basel reforms has reduced banks' appetite for structured product development. UK-regulated banks have been incentivised to reconsider different types of risk across legal entities, resulting in a significant reduction of overall market risk.

Basel 2.5 (Implementation in 2011)

Following the financial crisis, Basel 2.5 focused on addressing immediate short-term issues through increased risk-weighting requirements.

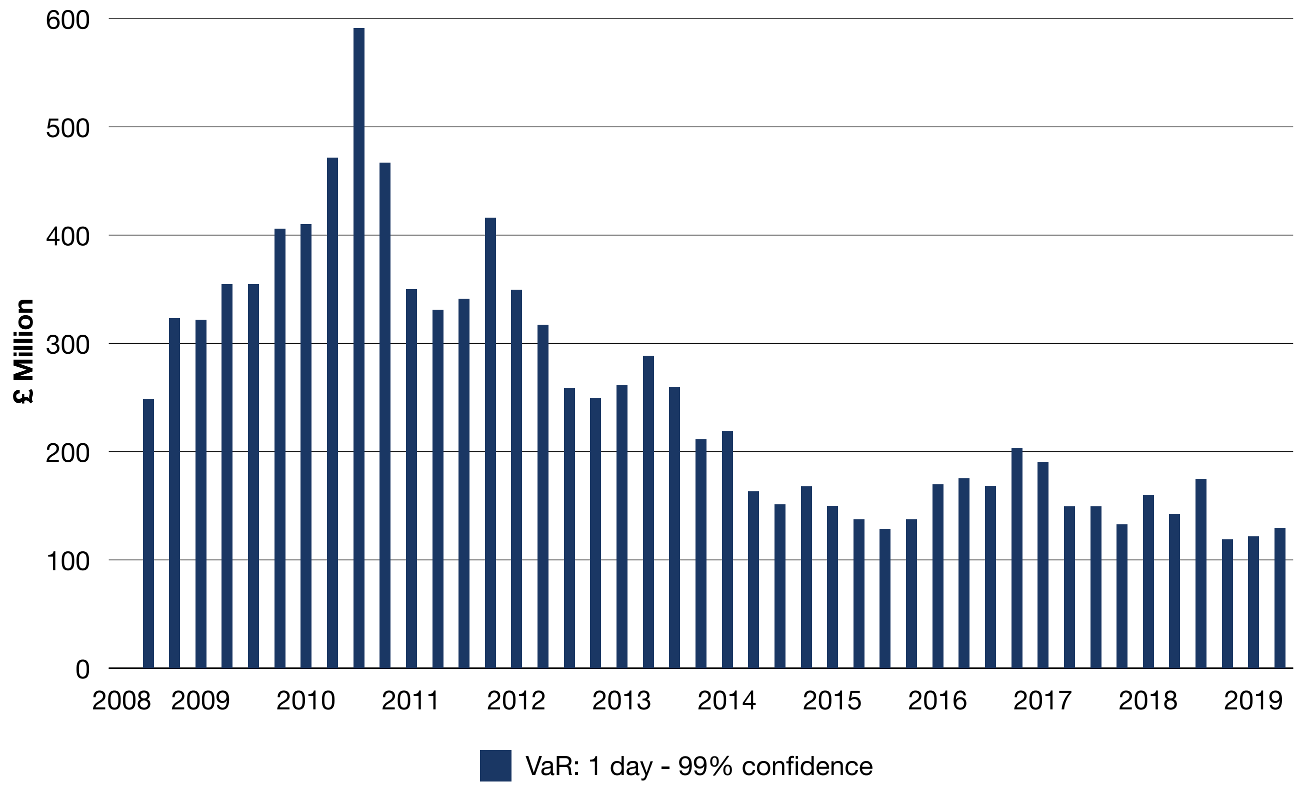
Coming into effect in 2011, the introduction of a stressed VaR measure and other Basel 2.5 reforms increased market risk capital requirements by an estimated 224%.[4] This corresponds with a marked reduction in market VaR measures from 2011 onwards as illustrated in Figure 6.1.

Basel 3, Basel 3.1, and the Fundamental Review of the Trading Book (Implementation by 2023)

Once implemented, the new framework is estimated to increase market risk capital requirements by 22% on average compared to Basel 2.5.[5]

The new framework should result in more activities and risks being accounted for under Pillar 1, with a corresponding reduction under Pillar 2.

Figure 6.1: Consolidated market risk of five largest UK banks - Value at Risk (VaR)

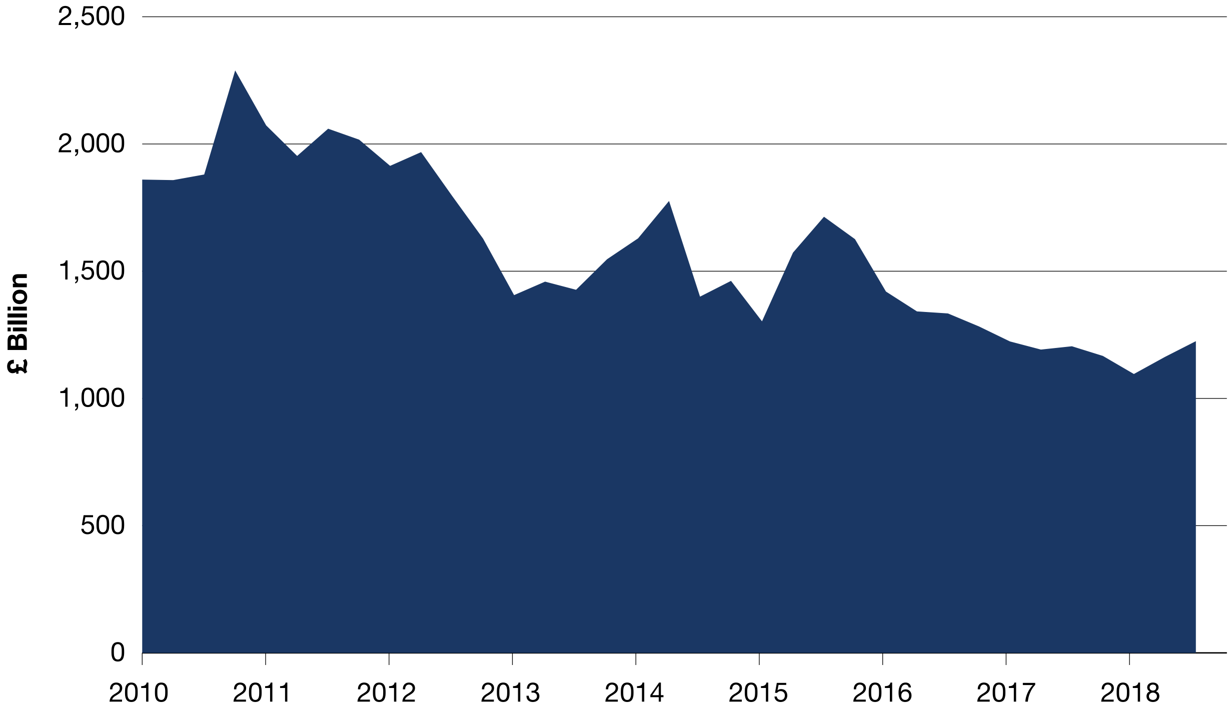


Source: Submissions from banks

4. *Basel Committee on Banking Supervision, 2009, Analysis of the trading book quantitative impact study. Available at https://www.bis.org/publ/bcbs163.pdf.*

5. *Basel Committee on Banking Supervision, 2019, Explanatory note on the minimum capital requirements for market risk. Available at https://www.bis.org/bcbs/publ/d457_note.pdf.*

Figure 6.2: Trading book assets of five largest UK banks



Source: Submissions from banks

PRA supervisory tools for mitigating proprietary trading risks

6.22 In line with its statutory objective to promote the safety and soundness of the banks that it supervises, the PRA's supervisory approach is anchored in three key principles: it is judgment-based; forward-looking; and focused on the key risks. Banks are assessed against current and potential risks, with the level of engagement proportionate to the risks posed by each bank.

6.23 Consequently, the PRA tailors its application of the risk assessment framework to consider the diversity of size, business model, and risk appetite of the banks in its perimeter, including those outside the ring-fence that potentially engage in proprietary trading activities.

6.24 The primary basis on which the PRA can regularly review the risks associated with proprietary trading activities is using monthly Management Information (MI) submissions from banks, which include internal risk assessments for ongoing activities, profit and loss (P&L) statements, business functions, and internal stress testing.

6.25 This is supplemented by more comprehensive statutory quarterly reports covering full P&L statements, balance sheets and risks, as well as annual submissions of capital requirement assessments provided through the Internal Capital Adequacy Assessment Process (ICAAP).

6.26 The monthly submissions form the basis of ongoing regular discussions, while quarterly and annual submissions are formally reviewed. **The Panel judges that the PRA's approach to supervising proprietary trading activities and mitigating risks to the safety and soundness of banks is appropriate and comprehensive.** This conclusion has been reached through engagement with the PRA supervisory teams and the relevant banks. Further details are outlined in Box 6.2.

Box 6.2: PRA supervisory approach

The PRA takes a qualitative approach to horizon scanning, with a focus on wider market trends rather than a granular analysis of individual bank transactions. Its primary concern is to maintain a clear view of business and risk performance, complemented by a wider understanding of trends and topical developments in the markets it supervises.

Extensive engagement between PRA supervisory teams and larger banks on market risks, as well as frequent submissions from banks, ensures that market risk estimates and regulatory capital calculations (Pillar 1 and 2) reflect up to date risks. In doing so, PRA supervision operates horizontally across banks and vertically across products, equity positions, and tech innovation.

The annual cycle of deep dives is driven by the priorities of individual supervisory areas. These will typically involve a substantial review of a specific business line. Proprietary trading may feature as part of these deep dives if questions arise about trading activities without a clear rationale. Although not directly identified as a supervisory priority area by the PRA, an uptick in proprietary trading could prompt further investigation into a bank's activities.

In parallel, periodic on-site reviews of activities and processes ensure appropriate follow-up action, including further engagement and investigation if required. Informal solutions are a more common approach to address issues, but a formal framework for escalation through the PRA senior committees remains available to supervisors if needed. This includes initial discussions with individuals and bank management, and a wider conversation with the relevant bank. The PRA specialist supervisory division will then decide on further steps, which range from a higher degree of monitoring of an individual and/or bank, to a formal letter to bank senior leadership inviting a follow-up conversation about the issues identified.

Wider regulatory reforms

6.27 In addition to the specific statutory powers and monitoring tools available to the PRA, it was considered whether the absence of 'classic' proprietary trading activities in NRFBs may be attributed to wider changes in banks' risk profiles and risk management practices.

6.28 The assessment points to significant prudential reforms resulting in a dampened appetite for proprietary trading and speculative activity. The additional accountability requirements on individuals contained in the SM&CR have reduced the incentives of individuals to take on positions that may expose a bank to excessive risk.

6.29 **The remuneration models that banks now use are materially different to those prior to the GFC.** Regulatory requirements now require performance-related pay to be deferred for set periods, and absolute caps limit performance-related pay to 100% of fixed pay. This effectively removes previous remuneration models that linked the profitability generated by individual traders with the remuneration that they receive. As a result, traders who specialise in 'classic' proprietary trading are not financially incentivised to work in the banking sector, limiting the ability of banks to employ traders with those specialist skills.

6.30 **It is likely that the restrictions on proprietary trading in other jurisdictions have impacted on the behaviour of banks operating in the UK.** Given the international profile of large banks in the UK that would be undertaking trading activities, there is some evidence to suggest that they streamline the types of trading activities that they undertake across the different jurisdictions.

6.31 When reviewing the regulatory returns from banks that set out what types of trading activities they do undertake, a significant majority used the US Volcker Rule as the reference point for outlining that they do not undertake 'classic' proprietary trading, rather than any definitions used in UK regulations. Most of the banks in question are active in US markets, and so having systems in place to comply with those restrictions is likely to have impacts on their trading business in the UK.

6.32 As noted, there are similar prohibitions in France, Germany, and Belgium, which are large markets for banks to operate in, and so the UK is likely seeing the resulting behaviour of banks being replicated in the UK, despite there not being restrictions on proprietary trading in the UK, other than within RFBs.

Proprietary trading in non-banks

6.33 While the Panel was not tasked with reviewing the proprietary trading activities undertaken in the non-bank sector, during the Review the analysis did raise some issues that the Panel considered important. As a result, this section outlines some interesting areas that were identified in the non-bank sector, rather than representing a comprehensive assessment of related risks.

6.34 Similarly, the non-bank sector falls largely outside of the PRA's supervisory perimeter. Consequently, it was important to explore the extent to which the continuation of proprietary trading activities in the non-bank sector may pose a risk to the UK banking system either through contagion or spill-over.

6.35 One important area that was noted is that regulators do not routinely collect information regarding the concentration of specific proprietary trading risks outside of the banking sector. In addition, changes brought in by the EU's Markets in Financial Instruments Directive (MiFID) II reporting requirements mean that comparable data relating to trading transactions is only available from 2018 onwards.

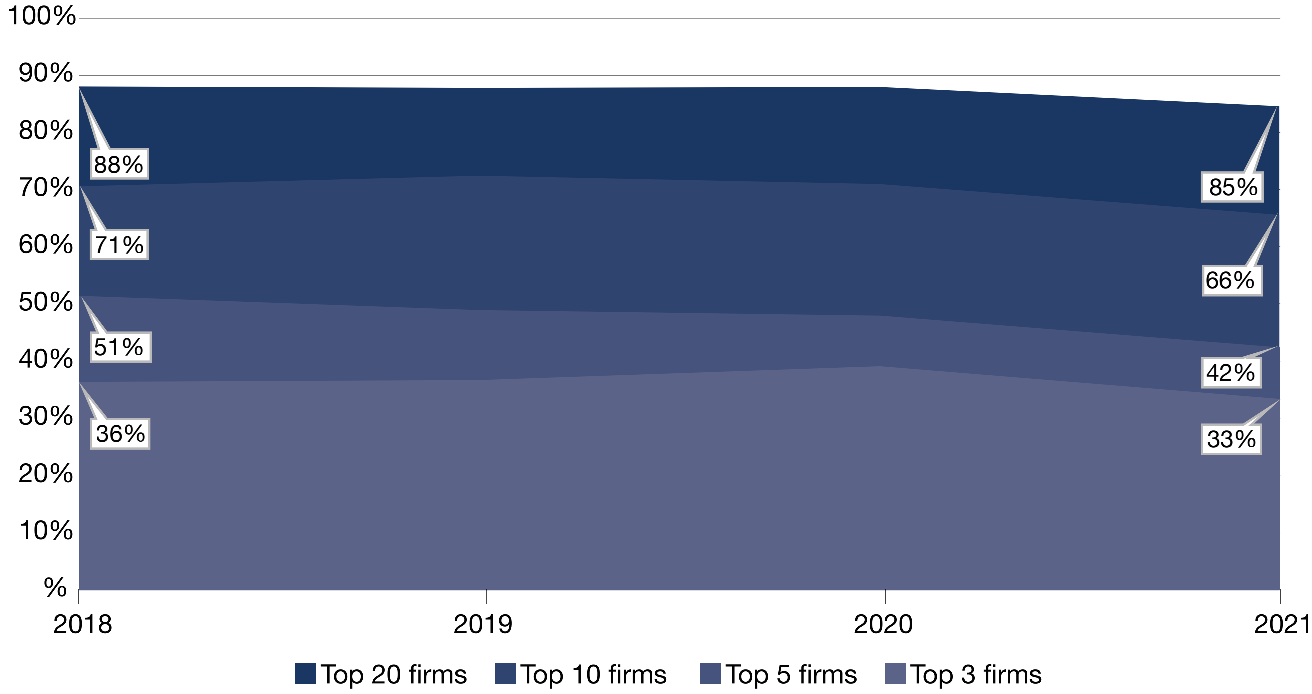
6.36 Based on a wide range of regulatory evidence, significant 'classic' proprietary trading activity is undertaken in the non-bank sector, primarily represented by principal trading firms and hedge funds. Principal trading firms undertaking high-frequency trading are prevalent in markets that trade electronically and act as substantial short-term liquidity providers.

6.37 Although a detailed breakdown of concentration risk outside the banking sector is not easily accessible, analysis shows that UK banks constitute only a small proportion of the total volume of principal trading activity, at roughly 10%.[6]

6.38 Of the top 20 firms that account for almost 90% of principal trading activity in the UK, seven are non-banks. The proportion of trading activity in the non-bank sector is therefore significant, as illustrated in Figure 6.3 and Figure 6.4.

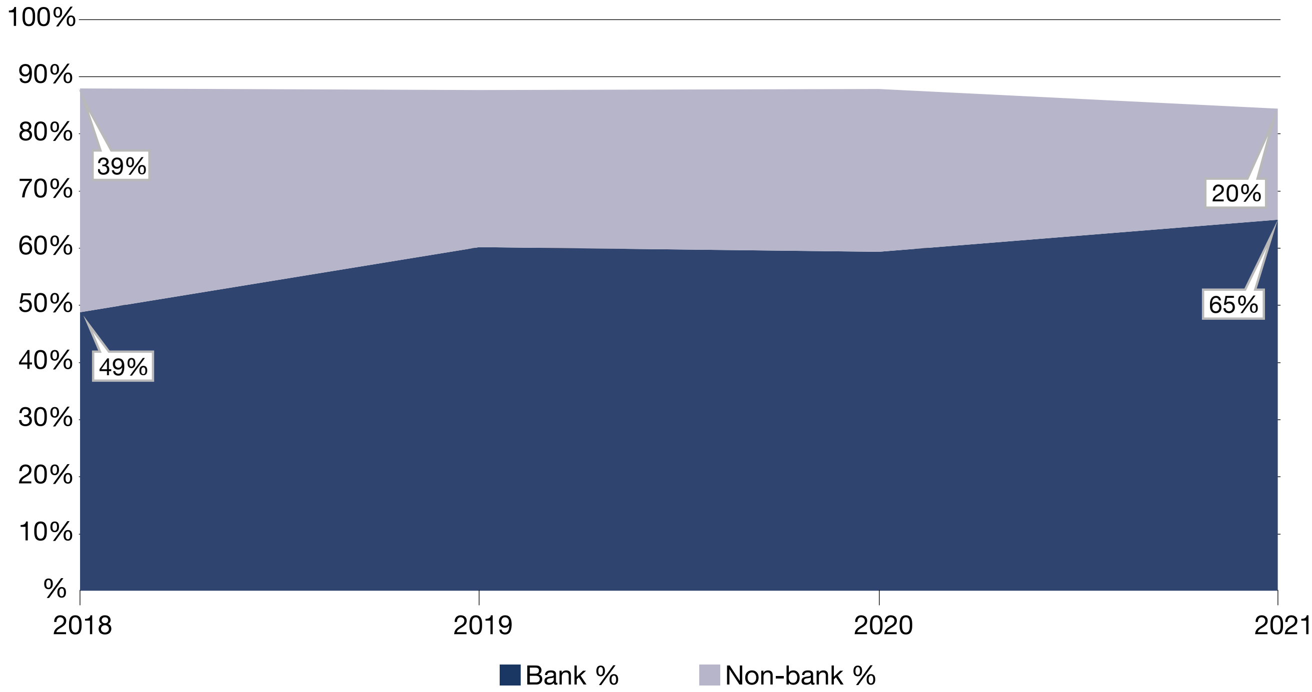
6. *Confidential data provided by the FCA.*

Figure 6.3: Firms' proportion of total principal transactions



Source: Submissions from FCA

Figure 6.4: Top 20 firms' proportion of total principal transactions by sector



Source: Submissions from FCA

FCA supervisory remit, monitoring processes, and firm reporting requirements

6.39 **Firms in the non-bank sector are regulated and supervised primarily by the FCA.** It is worth noting that the FCA's coverage of the non-bank sector overlaps with the role of the FPC, given the FPC's statutory responsibility for monitoring and mitigating risks in the broader financial system. The remit letter from HM Treasury to the FPC in 2020 asked for an assessment from the FPC of the risks posed by the non-bank sector.[7] The FPC published an assessment in the Financial Stability Report of July 2021.

6.40 Whilst recognising the comprehensive nature of FCA supervisory powers and tools, data collection and monitoring processes for proprietary trading activities in the non-bank sector are not systematically undertaken or segmented. This is also an issue that was identified by the FPC in its July 2021 report, noting the need to "enhance data on the non-bank financial sector […] so that regulators are better able to assess the resilience of the sector and risks to it." This points to a wider question around the need for cross-authority data collection and sharing, and undertaking more regular exercises to document the risks over time.

Box 6.3: FCA powers and supervisory tools[8]

FCA monitoring processes are underpinned by its supervisory principles. In particular for proprietary trading risks, the Panel notes the FCA's principles relating to being forward looking, as well as being focused on strategy and business models, on culture and governance, and on individual accountability as well as firm accountability.

Specifically in relation to supervision of firms, the FCA approach looks to be proportionate and risk-based, and based on two-way communication. Given the large number of firms that fall under the FCA's supervision, the FCA supervises most firms as members of a portfolio that share common business models. It analyses each portfolio and agrees a strategy to take action on firms posing the greatest harm.

Dedicated supervision teams focus on firms with the greatest potential impact on customers and markets. Where appropriate, firms are subject to additional requirements, such as ongoing prudential and liquidity adequacy assessments, regular liquidity reviews, and ongoing assessment of specialist supervision areas (technology resilience, cyber etc). There is also an expectation that senior hedge fund managers comply with SM&CR regulations.

Separately, algorithmic trading firms are required to perform an annual Self-Assessment and validation process to comply with the MiFID II concerning the testing of trading algorithms. MiFID II transactional data, and to a lesser extent European Market Infrastructure Regulation (EMIR) trade reporting, indicate firms' respective footprints across different markets and portfolios, as well as flag potential market abuse or market integrity issues. This is supplemented by order book data, which indicates quality of liquidity provision across markets.

Risks emanating from proprietary trading activities in the non-bank sector

6.41 **As well as direct risks to individual banks' resilience, prime brokerage lending can contribute to the crystallisation of systemic risks.** The recent failure of Archegos as outlined in Box 6.4, illustrates this potential for systemic risk from trading through prime brokers which can impact banks, even if originated in non-banks.

7. *HM Treasury, 2020, Financial Policy Committee remit. Available at https://www.gov.uk/government/publications/remit-and-recommendations-for-the-financial-policy-committee-budget-2020.*

8. *At the time of publication, Box 6.3 reflects FCA supervisory powers and tools. These are regularly reviewed. Latest information is on the FCA website at https://www.fca.org.uk/publications/corporate-documents/our-approach.*

6.42 As noted, the Panel considers that effective and timely data collection and sharing processes are particularly important for the authorities, given indirect channels of exposure via prime brokerage and potential build-up of systemic risks in certain parts of the non-bank sector.

Box 6.4: Risks in non-banks - Archegos case study

The recent failure of the investment fund Archegos has brought to the fore existing regulatory and supervisory concerns relating to prime brokerage and the build-up of risk in the non-bank sector. The significant scale of losses worth $10 billion was likely triggered by several factors, including poor risk management and low transparency.

Archegos held very concentrated positions in a few stocks across multiple prime brokerage accounts and reportedly entered several unusually leveraged derivatives transactions through total return swaps, facilitated by major investment banks. This allowed Archegos to gain exposure to a deeper pool of funds. Banks were less able to scrutinise the fund's risk management across its entire portfolio as Archegos did not have to report such transactions.

Archegos had exposure to the same portfolio across multiple brokerages, which meant that when Archegos exited some of its portfolio, it would trigger an amplified feedback loop in the value of the remaining portfolios. The cumulative effect led to a fire sale of assets when Archegos failed to meet an initial margin call.

Conclusions

6.43 'Classic' proprietary trading is no longer an activity carried out in the UK banking sector. This has largely been attributed to increased liquidity and capital requirements, the inception of the SM&CR, as well as lower risk appetites of banks. Other factors underpinning the decline in activity include restrictions in other jurisdictions. The analysis highlights that other types of proprietary trading such as hedging activities are routinely undertaken by banks.

6.44 The Panel assesses the risks of conducting proprietary trading activities in the UK bank sector to be appropriately mitigated, and PRA powers are currently sufficient to manage any associated risks.

6.45 'Classic' proprietary trading activity is undertaken in the non-bank sector, often in hedge funds and principal trading firms, especially in markets that operate electronically. Direct risks to banks are therefore reduced. However, indirect risk exposure from the non-bank sector remains.

6.46 Risk monitoring and management of non-bank financial institutions sits across the financial authorities, largely under the regulatory perimeter of the FCA, and to the extent they create systemic risk, the FPC.

PART III: PACKAGE OF RECOMMENDATIONS

Chapter 7

Recommendations

Recommendations at a glance

Ring-fencing recommendations
1. Change the scope of the ring-fencing regime to focus on large, complex banks a) Banks with deposits below £25 billion should continue to be exempt from the ring-fencing regime; b) Banks with deposits above £25 billion that do not undertake excluded activities above a certain level should be exempt from the ring-fencing regime; c) Only excluded activities above that level should be required to be placed in an NRFB.
2 Align the ring-fencing regime with the resolution regime a) HM Treasury should review the practicalities of how to align the ring-fencing and resolution regimes, with a view to introducing a new power for the authorities to remove banks from the ring-fencing regime that are judged to be resolvable.
3. Adjust the restrictions on servicing relevant financial institutions (RFIs) a) An exemption should be introduced to allow RFBs to provide banking services to smaller RFIs; b) The definition of RFIs should be moved from legislation to the PRA Rulebook; and c) A grace period should be introduced for NRFBs to move customers that are no longer classified as an RFI to an RFB.
4. Improve the operation of the ring-fencing regime through technical amendments a) Transitional periods for complying with ring-fencing rules should be introduced for mergers and acquisitions of banks; b) NRFBs should be enabled to service central banks outside of the UK; c) The status of trustees and insolvency practitioners should be clarified; and d) The notice of declaration onboarding requirement for NRFB customers should be removed.
5. Remove the blanket geographical restrictions from legislation that prevent RFBs from establishing operations or servicing customers outside of the EEA **6. Review the excluded activities under the ring-fencing regime** **7. The Bank of England should ensure that sufficient plans are in place as part of its contingency planning to provide liquidity to NRFBs in a stress scenario**
Proprietary trading recommendations
8. Monitor risks from proprietary trading activities undertaken by banks in the UK **9. Monitor and mitigate potential risks emanating from proprietary trading activities undertaken in the non-bank sector**

Recommendations in detail

7.1 The recommendations in this chapter aim to address the key findings identified in the Report. For the ring-fencing regime, these focus on the immediate issues faced by customers, banks, and regulators, as well as options to address the ring-fencing regime's primary purpose of tackling too-big-to-fail, and consequently its alignment with the resolution regime.

7.2 For proprietary trading, the recommendations reiterate the need to continue monitoring related risks in banks, as well as the potential risks from activities undertaken in the non-bank sector.

7.3 **The most significant changes that the Panel is recommending are in relation to the scope of the ring-fencing regime.** These recommendations stem from the Panel's conclusions that the financial stability benefits of the ring-fencing regime are relevant only when the regime is applied to large, complex banks, that banking services that are critical to the UK economy are undertaken by non-ring-fenced bodies, and furthermore that the resolution regime is now overtaking the ring-fencing regime in tackling too-big-to-fail. The Panel's other recommendations focus on the customers that banks are able to serve and the services that banks are permitted to provide them with.

7.4 The Panel's recommendations are designed to achieve the following:

a) Improve the outcomes for customers;

b) Maintain financial stability benefits and minimise risks to public funds; and

c) Reduce the rigidity and unintended consequences of the ring-fencing regime.

Recommendation 1: Change the scope of the ring-fencing regime to focus on large, complex banks

7.5 **As outlined in the Report, the financial stability benefits of the ring-fencing regime only arise when applied to large, complex banks.** It is the view of the Panel that the ring-fencing regime should only apply to banks where it provides a clear benefit for financial stability. The Panel recommends the following in relation to the scope of the ring-fencing regime:

a) Banks with deposits below £25 billion should continue to be exempt from the ring-fencing regime;

b) Banks with deposits above £25 billion that do not undertake excluded activities above a certain level should be exempt from the ring-fencing regime; and

c) Only excluded activities above that level should be required to be placed in an NRFB.

a) Banks with deposits below £25 billion should continue to be exempt from the ring-fencing regime.

7.6 The existing deposit threshold of £25 billion was reviewed to consider whether the level is still appropriate. The Panel considered stakeholders' suggestions outlining the need to increase the £25 billion threshold to account for inflation, GDP growth and other measures, as well as potential benefits for competition in the savings market.

7.7 The Panel also considered increasing the threshold as a means of providing an exemption for the less complex banks based on the conclusion that applying the ring-fencing regime to them does not create financial stability benefits.

7.8 The Panel considered whether changing the threshold would impact on financial stability, competition, and competitiveness. Having considered the option carefully, the Panel judges that the £25 billion threshold exemption should be kept at its current level for the following reasons.

7.9 First, analysis on the competition benefits for savers from increasing the threshold concluded that the impact would be negligible, as interest rate policy is likely to remain the main driver of market interest rates on savings.

7.10 Second, the original rationale for setting the threshold at £25 billion was set out by HM Treasury as being judgment based to capture the relevant banks, rather than a scientific measure.[1] Changing the £25 billion threshold in line with GDP growth, inflation, or other metrics over the last three years would result in an immaterial change to the threshold and would not alter the composition of banks in the regime.

7.11 Finally, increasing the threshold could negatively impact on the competitiveness of UK banks. Although the Panel concluded that the current level has not materially impacted on the competitiveness of UK banks, as outlined in Chapter 4, it acknowledged that there is the potential to do so if more banks adopted a model of funding investment banking activity using deposits below the threshold. Increasing the threshold could increase the volume of deposits used in this way.

7.12 Related to the last point, submissions were also received proposing a reduction in the £25 billion threshold as it created regulatory arbitrage by allowing some banks below the threshold to fund investment banking using retail deposits. However, as noted this has not created a meaningful impact. Reducing the threshold would bring in scope some smaller banks that HM Treasury originally intended to exclude due to disproportionate costs of compliance relative to the financial stability benefits.[2]

7.13 **Therefore, the Panel has judged that the deposit threshold should remain at £25 billion.** To address the issue of less complex banks being within scope of the ring-fencing regime, the Panel considers that adding another exemption for banks based on the activities that they undertake would be a better approach, as discussed in more detail in this chapter.

b) Banks with deposits above £25 billion that do not undertake excluded activities above a certain level should be exempt from the ring-fencing regime

c) Only excluded activities above that level should be required to be placed in an NRFB

7.14 **Applying the ring-fencing regime to banks that do not undertake excluded activities does not create financial stability benefits.** However, setting a new exemption for banks that undertake zero excluded activities would create new cliff edges and introduce more rigidity into the ring-fencing regime. It would therefore be better to set an exemption level for these activities just above zero, referred to in this chapter as a 'de minimis' level.

7.15 'Excluded activities' refer to the activities and exposures that are defined in legislation that RFBs are not allowed to undertake and therefore must be undertaken in an NRFB. The list of excluded activities that are measurable in value terms is set out in Annex B, Section 2. The de minimis test should focus on these excluded activities. One approach to measuring these activities would be to:

a) Use an average over a three-year period, which would avoid any sudden triggering of an exemption;

b) Use gross values rather than net values, which would ensure against under-estimating the level of activity; and

c) Measure the activities of a UK group or alternatively the activities undertaken in the UK of a whole group, including branches.

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1. *Parliamentary Commission on Banking Standards, 2012, First Report, Section 199. Available at https://publications.parliament.uk/pa/jt201213/jtselect/jtpcbs/98/9813.htm.*

2. *HM Treasury, 2012, Banking reform: delivering stability and supporting a sustainable economy, page 31.*

7.16 **Banks with a total value of these activities below a de minimis level would be exempt from the ring-fencing regime.** In setting an appropriate de minimis level, one approach would be to set the level as a percentage of the capital of the bank. This draws on the approach taken by the Basel Committee in setting banks' exposure limits to borrowers.

7.17 For example, setting a de minimis level below 10% of UK tier 1 capital would be small, equivalent to only 0.3-0.5% of a bank's balance sheet or 1.5-2.0% of risk-weighted assets (RWAs). It draws on what the Basel Committee defines as one large exposure to one borrower. A de minimis level below 10% would provide an exemption only for banks with minimal excluded activities.

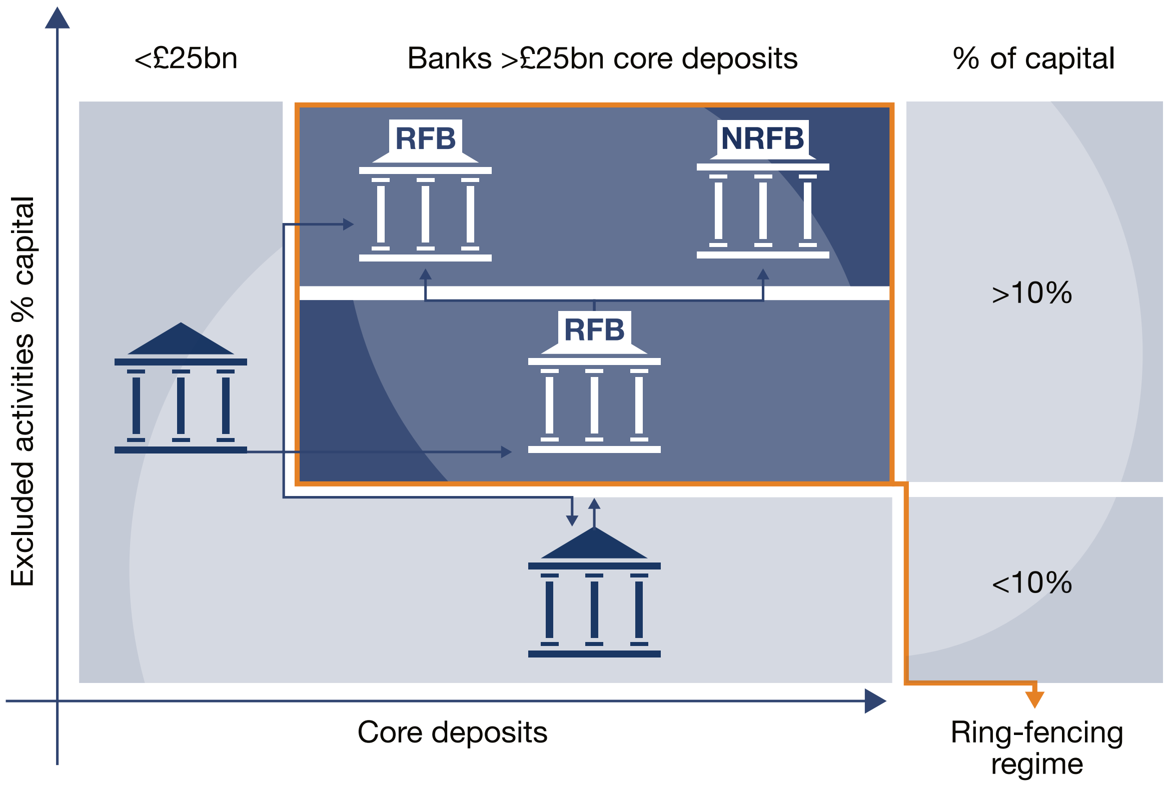
7.18 A bank with more than £25 billion deposits that moves above this de minimis level would then be subject to the requirements of the ring-fencing regime. To avoid cliff edges, the Panel suggests to only require the banks to place the excluded activities above the de minimis level into a separate legal entity – the NRFB.

7.19 The banks in scope of the regime have already established RFB and NRFB entities. **The real practical implication of only requiring excluded activities above a de minimis level to be placed in an NRFB would be to give the RFB the ability to undertake a de minimis level of excluded activities within the ring-fence.** At this point, the de minimis level of activity allowed within the RFB could be set in relation to the capital held by the RFB rather than the wider group.

7.20 Figure 7.1 illustrates how this recommendation could work. A small difference between the percentage level at which a bank enters the ring-fencing regime and the point at which excess excluded activities are required to be placed in the NRFB would create a smoother path into and out of the ring-fencing regime.

7.21 Some restrictions for RFBs do not have a value and cannot be 'moved' to an NRFB, such as requirements for RFBs to have direct access to interbank payment systems, requirements to have an independent board, and restrictions on using shared services within a group. These would remain as absolute requirements for RFBs. For a bank exempt from the ring-fencing regime, it would not be required to have an RFB and therefore would not be subject to the requirements that apply to RFBs.

Figure 7.1: Example of de minimis exemption operating in the ring-fencing regime



Rationale and financial stability impacts

7.22 The Panel considered the impacts of this recommendation, including the impact on banks' behavioural responses. An exemption based on the value of excluded activities in addition to the volume of deposits would place a ceiling on a large bank's ability to grow excluded activities when outside of the ring-fencing regime.

7.23 **With this approach, a bank with more than £25 billion in core deposits would need to keep the value of the excluded activities below the de minimis level or else it would be subject to the ring-fencing regime.** This is also important to ensure that banks outside the ring-fencing regime would not have an unfair competitive advantage over RFBs operating within the ring-fencing regime.

7.24 In order for banks above the £25 billion deposit threshold to use this exemption, they would need to monitor and report all excluded activities to demonstrate that these remain below the de minimis level. This additional monitoring and reporting requirement would require detailed monitoring of the risks while outside of the ring-fencing regime, mitigating incentives for banks to expand this activity beyond what is necessary. Banks not using this exemption, for example those who far exceed the de minimis level or those below the £25 billion deposit threshold, would not need to monitor and report these excluded activities.

7.25 Similarly, if RFBs choose to undertake excluded activities below the de minimis level, they would need to monitor and report all the excluded activities within the RFB. This additional monitoring and reporting requirement would be prudent to mitigate risks.

7.26 In judging, for example, that a level of 10% of tier 1 capital is low enough to not introduce financial stability risks, the Panel considered a number of factors. First, as already noted this level would represent only between 0.3-0.5% of a UK bank's balance sheets, or 1.5-2.0% of RWAs.

7.27 Second, by setting the limit at 10% of tier 1 capital, any increase in the value of excluded activities at the margin would need to be matched by ten times that value in tier 1 capital.

7.28 Third, this de minimis level would be the maximum for the total value of all excluded activities and exposures for a bank. In contrast, the same level is used for just the reporting stage of one exposure of a bank to just one borrower. The Panel considers this example to be a reasonable de minimis level.

7.29 The Panel also considered whether this new exemption could be used by banks to circumvent the ring-fencing regime but noted that the only way this could be attempted is where a non-UK banking group operates a UK retail bank.

7.30 This risk is mitigated as banks in the UK that are retail focused are required to operate as separate legal entities to their non-UK parent group, normally referred to as a UK subsidiary. UK subsidiaries are authorised and regulated by the UK authorities. The PRA, FCA, and Bank of England have powers to ensure that UK subsidiaries operate independently from the non-UK parent group, both financially and operationally. The legal separation between a subsidiary and parent group is similar to how the ring-fencing regime imposes legal separation between a subsidiary and parent group, and could be re-enforced with stronger supervision if deemed necessary. As a result, any attempt to use this exemption by non-UK banking groups as a way to circumvent the regime would result in a similar legal separation to that of the ring-fencing regime.

7.31 **Overall, the Panel's assessment is that providing an exemption for banking groups with minimal levels of excluded activities would not undermine the resilience of the banks and would not increase financial stability risks** as:

- banks' excluded activities would need to stay below the de minimis level; and
- the PRA, FCA, and Bank of England have sufficient powers to exercise over UK subsidiaries of non-UK banking groups.

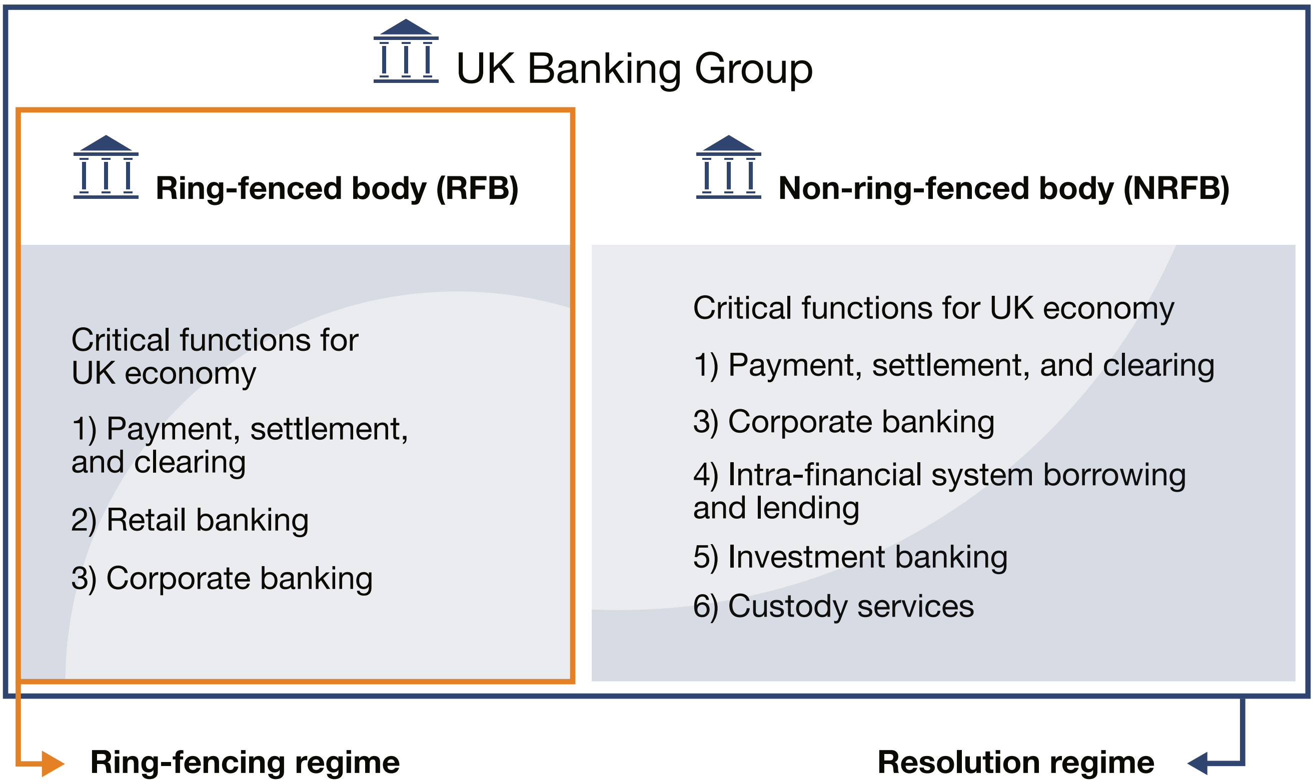
Recommendation 2: Align the ring-fencing regime with the resolution regime

7.32 As outlined in the Report, the ring-fencing regime and the resolution regime both aim to ensure the continuity of critical functions and address too-big-to-fail in the event of a bank failure. However, both regimes approach this differently as detailed in Chapter 3.

7.33 The Panel's view is that the resolution regime is now overtaking the ring-fencing regime in tackling the issue of too-big-to-fail and can provide a more comprehensive solution. Therefore, in aligning the regimes the more dynamic resolution regime should be prioritised over the ring-fencing regime going forward.

7.34 **An effective way of aligning both regimes would be to introduce a new power for the authorities to remove banks from the ring-fencing regime that are judged to be resolvable.**

Figure 7.2: Protecting critical functions: the ring-fencing regime and resolution regime[3]



a) HM Treasury should review the practicalities of how to align the ring-fencing and resolution regimes, with a view to introducing a new power for the authorities to remove banks from the ring-fencing regime that are judged to be resolvable.

7.35 **Before introducing a new power, HM Treasury should review the legislative and regulatory practicalities of the recommendation to ensure that wider powers, tools, and policies of the authorities are not lost as a result of removing resolvable banks from the ring-fencing regime.**

7.36 For example, the 'Other Systemically Important Institutions' (O-SII) buffer that applies additional capital requirements to banks with total assets above £175 billion is set with reference to banks in the ring-fencing regime. It is not the intention of the Panel to remove wider regulatory policies such as this one. Similarly, HM Treasury should review and consider other non-ring-fencing rules and powers that reference the ring-fencing regime to ensure that they continue to operate as intended.

7.37 The Panel considers that this new power could sit with one of the authorities and that it would not be an automatic trigger for banks. The power could be exercised in consultation between the Bank of England as the resolution authority, the PRA as the prudential regulator, the FCA in its role in protecting customers, and HM Treasury in its role in managing risks to public funds.

7.38 The exemption could be linked to a number of conditions being met before the power is exercised. These conditions could include:

a) A bank is judged to be resolvable by the Bank of England; and

3. *The PRA defines critical functions that firms provide to be: 1) payment, settlement, and clearing; 2) retail banking; 3) corporate banking; 4) intra-financial system borrowing and lending; 5) investment banking; 6) custody services; 7) life insurance; and 8) general insurance.*

b) A bank produces a plan on how it will operate outside of the ring-fencing regime in a way that does not undermine its resilience. This could be subject to approval by the PRA.

7.39 **The Panel recognises that the judgment around resolvability is not binary.** It could be aligned with the existing annual resolution planning process and/or the RAF process detailed in Chapter 3.

7.40 The proposed conditions are not intended to be exhaustive. The approval process for using the power could allow the Bank of England to impose requirements that it deems important for the resolution of a bank, and allow the PRA to impose requirements that it deems important for a bank's resilience. This way, they can ensure that their respective objectives are not undermined.

7.41 **Given that a new power would likely require a full review of legislative implications as well as primary legislation, the Panel recognises that this new approach would not be operational for at least a few years.** Noting this timing, the Panel considers it imperative to begin a review as soon as practicable.

Rationale and financial stability impacts

7.42 The Panel considered an alternative approach of incorporating the objectives of the resolution regime into the ring-fencing regime by requiring RFBs to hold all critical functions, leaving only non-critical functions in an NRFB.

7.43 Such an approach would be in line with the structural reforms proposed in the Liikanen report to the European Commission in 2012, which suggested isolating the riskiest activities in a separate entity to the core banking activities that could then be placed into insolvency if a bank were to get into trouble.[4] However, this approach would require another fundamental and costly restructuring of the UK banking sector. Given that the EU did not take forward these recommendations, this model is untested and there is no evidence to suggest that it would offer a better structural solution than the existing ring-fencing regime.

7.44 The Panel's preferred approach is for the authorities to have more flexibility in addressing too-big-to-fail rather than proposing additional structural reforms that would be costly for industry.

7.45 The recommended approach could be progressed in a measured way that builds on the regulatory reforms that have been undertaken since the GFC. Doing so would not increase risks to financial stability, would not compromise the gains made in making banks resilient, and would not undermine the resolvability of banks.

7.46 **First, the resolvability assessment by the Bank of England would not need to be an automatic trigger for banks exiting the ring-fencing regime, and conditions could be set to satisfy the authorities before exemptions are granted.** The onus could be put on the banks rather than the authorities to demonstrate that they have met the appropriate conditions.

4. *Erkki Liikanen, 2012, Reforming the structure of the EU banking sector, Available at https://ec.europa.eu/info/publications/liikanen-report_en.*

7.47 **Second, the largest UK banks have already undertaken significant restructuring of their businesses to simplify how they operate.** As a result, the starting position for banks is vastly different to where they were before the financial crisis. The Bank of England already has powers and tools that it can exercise under the resolution regime to require banks to take the necessary steps to remove barriers to resolvability. Under the Panel's proposed new power, any proposals put forward by a particular bank to move away from the status quo would need to demonstrate to the Bank of England that they do not undermine resolvability. To the extent that additional steps – structural or otherwise – are necessary for resolution purposes, these could be imposed using resolution powers. Furthermore, this new power would give the PRA approval over any new proposals to ensure that a bank's resilience is not weakened.

7.48 This approach would introduce flexibility into the current structures of the ring-fencing regime to better align with the objectives of the resolution regime, ensuring that all critical functions are able to continue rather than only critical functions in retail banking. The supervision of banks, the improvement of resilience, and the development of resolvability would continue to be ongoing iterative processes.

7.49 **Third, this new power could be used on a bank-by-bank basis.** This would reflect the fact that not all banks would necessarily be judged to be resolvable at the same time. In addition, different banks would have different commercial and strategic objectives both in the UK and internationally, as well as different challenges in achieving resolvability. Given the small number of banks that are subject to the ring-fencing regime, a forward-looking, judgement-based approach would be more agile and dynamic than the one-size-fits-all approach of the ring-fencing regime. This would be in line with the PRA's approach to supervision and in line with the principles of the Future Regulatory Framework (FRF).

7.50 **Fourth, the overall priority for the authorities should be to tackle too-big-to-fail in order to minimise risks to public funds.** The most efficient way to achieve that, while ensuring coherence and simplicity within the UK's regulatory framework, is to ensure that banks are resolvable. This is critical as the UK does not operate a zero-failure regime. This new power could provide additional incentives for banks to prioritise their resolution plans in addition to their existing legal obligations to remove remaining barriers to resolvability. This would be aligned with the objectives of the Bank of England as the resolution authority and HM Treasury in managing risks to public funds.

7.51 Finally, there are a number of areas where joint consultations are already held between the authorities when exercising powers, for example when authorising the use of stabilisation powers under the resolution regime.[5] In addition, the division of responsibilities and powers between the different authorities is set out in several different policy documents and has most recently been considered for the PRA in the context of the FRF review. In operationalising this recommendation, principles from these examples could be useful precedents for HM Treasury when considering the practicalities of a new process between the authorities to ensure that the appropriate levels of governance, accountability, and transparency are in place.

5. *HM Treasury, 2020, Banking Act 2009: special resolution regime code of practice. Available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/945165/SRR_CoP_December_2020.pdf.*

Recommendation 3: Adjust the restrictions on servicing relevant financial institutions

7.52 The Panel recommends the following in relation to RFIs:

a) An exemption should be introduced to allow RFBs to provide banking services to smaller RFIs;

b) The definition of RFIs should be moved from legislation to the PRA Rulebook; and

c) A grace period should be introduced for NRFBs to move customers that are no longer classified as an RFI to an RFB.

7.53 Regarding the exemption for smaller RFIs, the Panel considers that a viable approach would be to use the definition of SMEs under the UK's retained EU law, in particular from the EU Capital Requirements Regulation. This includes enterprises with fewer than 250 employees and an annual turnover of less than €50 million, and/or a balance sheet total not exceeding €43 million.

Rationale and financial stability impacts

7.54 As outlined in Chapter 5, the absolute prohibition for RFBs having exposures to RFIs is causing unnecessary difficulties for customers in accessing basic banking services and government schemes. Exposures to relatively small RFIs can be managed sufficiently through other existing regulatory requirements, including liquidity and capital requirements.

7.55 **The approach to setting an exemption for RFIs based on size would result in sensible outcomes for banks and RFIs, without increasing risks to the resilience of banks or the wider financial system.**

7.56 The list of financial institutions captured by the RFI definition in legislation is broad, complex, and in some cases out of date, as explained in Chapter 5. It would be prudent to move the definition of RFIs from secondary legislation to the PRA Rulebook, where it can be more easily updated to reflect changing circumstances and avoid creating future unintended consequences.

7.57 Finally, as set out in Chapter 5, there is no grace period for NRFBs to move a customer to the RFB if the customer is no longer classified as an RFI. This creates a disproportionate monitoring and compliance process for NRFBs, potentially resulting in poor outcomes for customers. It would seem logical to have a grace period for when customers are reclassified. This would not pose a financial stability risk or undermine the resilience of banks.

Recommendation 4: Improve the operation of the ring-fencing regime through technical amendments

7.58 The recommendations to make some operational amendments are set out based on the issues outlined in Chapter 5. The Panel also received submissions from stakeholders on a range of other technical amendments that are set out in Annex B, Sections 3 and 4. These should be considered by the authorities if re-drafting legislation.

a) Transitional periods for complying with ring-fencing rules should be introduced for mergers and acquisitions of banks

7.59 A transition period should be introduced for banks that are subject to the ring-fencing regime when acquiring or merging with a bank that is not subject to the ring-fencing regime. The PRA could be empowered to grant the transition period. As with similar introductory periods, four years may be appropriate.

b) NRFBs should be enabled to service central banks outside of the UK

7.60 Central banks outside of the UK should be reinstated on the list of entities that NRFBs can have exposure to, as listed in article 6 of the Regulated Activities Order 2001 (RAO). This seeks to address a consequence of the transfer of EU legislation into UK law, which removed all central banks outside of the UK from the list.

c) The status of trustees and insolvency practitioners should be clarified in legislation

7.61 The categories of clients as set out in the CAO should be amended to provide clarity on where more sophisticated clients are banked between the RFB and the NRFB.[6] Specifically, this should address the following clients:

- **Insolvency practitioners:** The CAO should be amended to clarify that an NRFB may take deposits from insolvency practitioners where corporate bodies and partnerships involved in insolvency proceedings have deposit accounts with the NRFB. An insolvency practitioner should be able to be banked on either side of the ring-fence depending on which firms they are acting for.
- **Pension scheme trustees:** The CAO should be amended to address how trustees and trusts are regarded when considering how the test on organisations under Article 5 of the CAO applies to them. This test should seek to focus on the subject matter of the trust rather than the individual circumstances of the trustees.

d) The notice of declaration onboarding requirement for NRFB customers should be removed

7.62 The NoD requirement should be removed as the original purpose was to facilitate the effective separation of NRFBs by 2019. This has been achieved. The requirement for NRFBs to issue an NoD to their customers unnecessarily lengthens the onboarding process. The removal of the NoD should result in the customer not being required to assess whether it meets the qualifying conditions to be banked by an NRFB. This process should remain an NRFB's responsibility. Where the status of a customer changes so that, as per the ring-fencing legislation, it must be moved from the NRFB to its RFB or vice versa, no additional declarations should be required.

Recommendation 5: Remove the blanket geographical restrictions from legislation that prevent RFBs from establishing operations or servicing customers outside of the EEA

7.63 As set out in Chapter 5, the current geographical restrictions prevent RFBs from undertaking activities outside of the EEA, for example operating a branch and servicing UK customers abroad. This does not amount to a material restriction, but it does create unnecessary difficulties for UK customers and businesses who want to continue banking with a UK bank while operating outside of the EEA. This is mainly impacting on smaller business customers in RFBs that do not meet the size criteria set by NRFBs for commercial reasons.

7.64 **The Panel recommends removing this blanket restriction from legislation to create a more flexible approach, empowering the PRA to allow RFBs to operate in some additional jurisdictions, where appropriate.** This could enable banks to better support UK businesses. The Panel is not recommending discarding all geographical restrictions on RFBs, but rather removing the absolute prohibition that is set out in legislation.

Rationale and financial stability impacts

7.65 Defining the limit of the geographical scope of RFB operations based on the EEA is now somewhat redundant given the UK has left the EU. Equally, tightening the restrictions to limit RFBs to the UK

6. *FSMA (Ring-fenced Bodies and Core Activities) Order 2014.*

only is not needed from a prudential perspective. Therefore, a more flexible approach where RFBs can be permitted by the PRA to operate and service customers in some other countries would enable a better response to future challenges and opportunities.

7.66 Separate to the ring-fencing regime, banks are required to go through multiple approvals processes for operating in other jurisdictions. This includes permission from the host regulator for the relevant jurisdiction. In addition, the PRA considers the strategic plans of RFBs regularly, including any plans to operate outside of the UK. The PRA already has powers and tools to manage RFBs operating in jurisdictions outside of the UK.

7.67 It is the Panel's view that the PRA is best placed to assess the relevant risks for RFBs operating in other jurisdictions**.** Assessing these risks on a forward looking and judgement basis is a better approach than defining geographical areas in legislation that results in inflexible restrictions.

7.68 **If the UK authorities would still prefer to set out jurisdictions that RFBs should confine their activities to on top of existing PRA powers, the Panel considers that a more flexible approach would be to set these out in the PRA Rulebook, with the EEA as a minimum starting point.** A clear rationale and set of objectives should accompany the basis for setting the jurisdictions, with appropriate processes in place for reviewing and providing exemptions where appropriate.

7.69 Finally, for the purpose of calculating the £25 billion core deposit threshold, EEA branches of an RFB are included. If this recommendation is taken forward, this reference would need to be updated.

Recommendation 6: Review the excluded activities under the ring-fencing regime

7.70 During the Review, the Panel received a number of submissions outlining the restrictions experienced by customers as a result of some activities being excluded from RFBs. These activities are set out in Annex B, Section 5.

7.71 As set out in Recommendation 1, the Panel considers that a de minimis amount of excluded activities should be permitted in an RFB without undermining the resilience of a bank. However, whether these activities should be allowed in an RFB without a limit is a question of risk appetite for the authorities. The Panel therefore considers that the authorities should review the list of activities in Annex B, Section 5, and consider whether there is a financial stability benefit or customer detriment from excluding activities from RFBs.

Recommendation 7: The Bank of England should ensure that sufficient plans are in place as part of its contingency planning to provide liquidity to NRFBs in a stress scenario

7.72 As outlined in Chapter 3, NRFBs have lower resilience to severe liquidity stresses than RFBs, as they have fewer contingency options in a liquidity stress. As the Report also outlines, NRFBs carry out critical functions, making them important in a scenario where a bank fails. To reduce the likelihood of failure from a liquidity shock, the Panel thinks it is critical that appropriate contingency plans for central bank liquidity insurance are in place for NRFBs to manage liquidity stresses, subject to standard solvency assessments.

Recommendation 8: Monitor risks from proprietary trading activities undertaken by banks in the UK

7.73 As outlined in Chapter 6, the Panel considers that the risks of proprietary trading activities in the UK banking sector are appropriately mitigated, and PRA powers are currently sufficient to manage any associated risks.

7.74 The PRA should continue to monitor and keep under review proprietary trading activities to manage any change in risk appetite amongst banks, regulatory changes in other jurisdictions, and future changes in financial markets.

Recommendation 9: Monitor and mitigate potential risks emanating from proprietary trading activities undertaken in the non-bank sector

7.75 As outlined in Chapter 6, 'classic' proprietary trading activity is undertaken in the non-bank financial sector, often in hedge funds and principal trading firms. Direct risks to banks are reduced. However, indirect risk exposure from the non-bank sector remains.

7.76 As part of ongoing work on non-bank regulation, the authorities should continue to work together to monitor and mitigate any potential risks emanating from proprietary trading activities in the non-bank sector.

Summary of benefits of the recommendations package

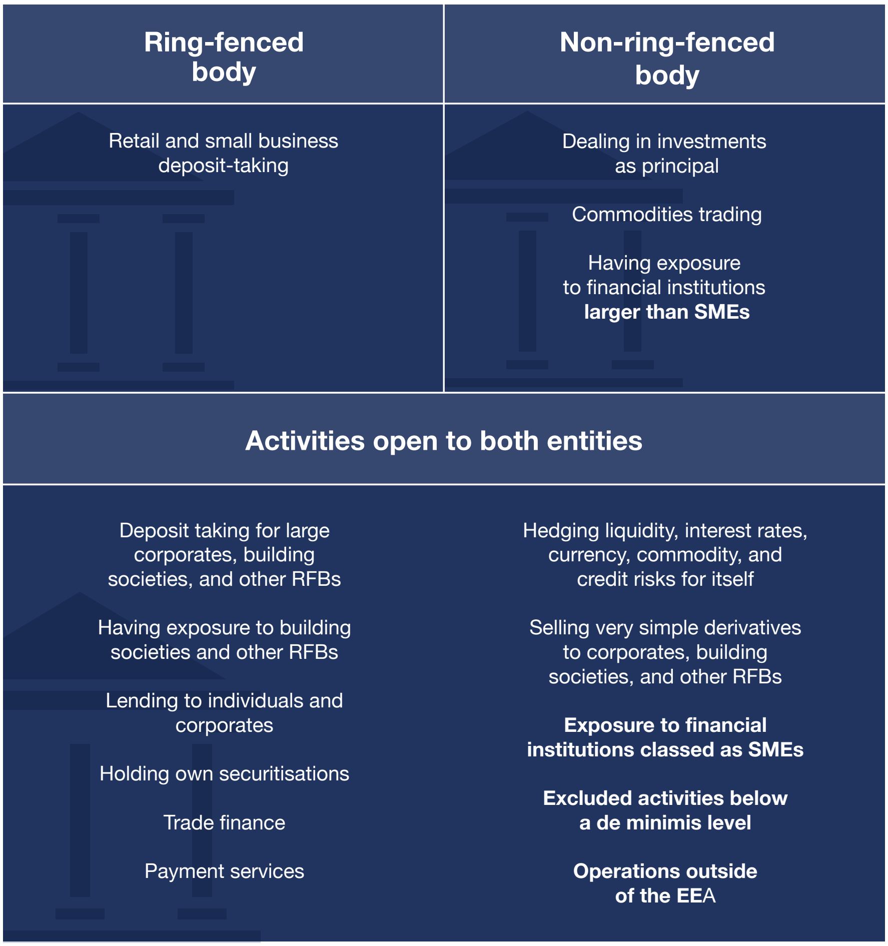
7.77 As set out for each individual recommendation, the Panel judges that the package of recommendations could be implemented without increasing risks to financial stability, while addressing the issues raised in the Report.

7.78 There are a number of potential benefits that could be realised from implementing the package of recommendations. **At the heart of the recommendations is the attempt to provide more flexibility to the authorities and banks so that they can adapt to customer needs using a forward looking, judgment-based approach, taking account of the associated risks as they evolve in a changing financial sector and economy. Importantly, the package lays the ground for future options to address the ring-fencing regime's primary purpose of tackling too-big-to-fail, and consequently its alignment with the resolution regime.**

7.79 In summary the package of recommendations:

- Keeps the core deposit threshold at £25 billion;
- Removes banks from the regime that undertake minimal excluded activities;
- Enables RFBs to undertake a small amount of excluded activities;
- Enables the authorities to remove banks from the regime that are deemed resolvable;
- Enables RFBs to provide smaller RFIs with banking services;
- Enables RFBs to provide customers outside of the EEA with banking services; and
- Makes some technical changes to improve the operation of the regime.

Figure 7.3: Proposed changes to activities for RFBs and NRFBs



Outcomes for customers

7.80 The impact on customers that straddle the boundary of the ring-fencing regime was a recurring issue identified by the Panel throughout the Review. These customers are mainly business customers of a medium size that are large enough to require some of the more complex banking services that an NRFB can offer, while also being too small to meet the size criteria set by NRFBs for commercial reasons. Some of these customers also provide services that technically resulted in them being classed as financial institutions.

7.81 Based on ring-fencing restrictions, banks have taken commercial decisions on the types of customers to service in the RFB and NRFB parts of the bank. As a result, in some cases business customers are unable to access services from either part of a bank resulting in them not being able to access even basic services. This is particularly the case for new businesses that have been set up since the ring-fencing regime came into place as they do not have existing banking relationships. As a result, this issue is likely to grow over time as new businesses are set up in the UK.

7.82 **In the UK, SMEs account for 99% of all businesses and so form an important part of the UK economy.** While the issues for businesses that fall between the RFB and NRFB are not widespread, the Panel strongly believes that banking regulations should not create additional barriers for businesses, in particular for new businesses, unless there is a financial stability benefit from doing so.

7.83 **The recommendations to change the restrictions for RFIs, remove geographical restrictions from legislation, and allow a small level of excluded activities in an RFB, are all designed with the customer in mind.** These are relatively modest changes that should not impact on the resilience of banks, while providing a lot more flexibility for banks to provide business customers with the essential banking services that they need.

7.84 Other technical amendments to the regime should also make it more efficient and cost effective for customers dealing with banks. Removal of redundant declarations should enable a smoother onboarding process for customers, and the provision of more services should reduce the need for customers to bank with multiple banking groups and different entities within a banking group.

7.85 The new exemption for retail banks that only undertake a small amount of excluded activities will also provide challenger banks and new entrants the ability to grow and scale up beyond the £25 billion core deposit threshold without being subject to ring-fencing requirements. This removes a potential barrier to growth, which should increase competition (or at the very least not restrict competition) in retail banking. This should be to the benefit of customers.

7.86 This goes to the heart of the provision of productive finance, providing British businesses with the support they need to grow, operate, and thrive.

Reducing rigidity and unintended consequences

7.87 The Panel repeatedly came across examples of rigidity in the application of the ring-fencing regime in everyday operations with regulators, banks, and customers. The primary drivers of this were the absolute restrictions on activities set in legislation.

7.88 **The Panel proposes to reduce this rigidity and increase flexibility through a series of new exemptions** and moving some restrictions out of legislation. In particular, removing less complex banks from the regime, enabling RFBs to undertake a small amount of excluded activities, enabling RFBs to provide smaller RFIs with banking services, and removing geographical restrictions from legislation should make the operation of the regime less rigid and more adaptable.

7.89 **In addition, the authorities will have much more flexibility in approving the longer-term strategies of banks with a power to remove and approve the plans of banks outside of the ring-fencing regime.**

Remaining risks to public funds

7.90 In setting out the terms of reference for the Review, HM Treasury specifically requested that the Panel considers whether the ring-fencing regime has met its intended purpose of supporting financial stability and reducing risks to public funds.

7.91 The risk to public funds has been reduced through the implementation of a number of banking reforms, as measured by the implicit government guarantee. However, the Report has quite clearly set out that risks to public funds remain despite the ring-fencing regime, as it only focuses on a sub-set of critical functions. The recommendations have set out a proposal to address this by aligning it with the resolution regime.

7.92 **The Panel felt strongly about raising the extent to which too-big-to-fail is tackled and setting out clearly what the ring-fencing regime does and does not protect.** In particular for HM Treasury, government, and Parliament, it is important to be fully aware of the remaining potential taxpayer risks so that they can take preparatory action as they deem necessary. In light of government interventions in response to the last financial crisis, and the fiscal burdens from the more recent Covid-19 pandemic, this remains an important consideration.

7.93 **The UK does not operate a zero-failure regime meaning that it is accepted that banks in the UK could fail in the future.** Based on the findings of this Report, the resolution regime provides the most comprehensive means of managing bank failures in an orderly way without seeking taxpayer support. It is now overtaking the ring-fencing regime and so it should be prioritised.

7.94 However, it is not possible to account for all future scenarios, and it is possible that the resolution regime is not able to fully deal with the failure of a bank, or a wider systemic issue. In such a scenario, it is important for HM Treasury to recognise that the ring-fencing regime will not act as a comprehensive fall-back option. It is possible public funds will still be needed to ensure critical banking services continue and to potentially shore up wider systemic impacts on the UK economy. Having a clear understanding of these financial risks to the taxpayer should enable HM Treasury to act accordingly in advance.

Adapting to future opportunities and risks

7.95 **The UK financial sector continues to evolve and innovate in response to changing customer needs, technological developments, and a competitive landscape.** Even since 2011 when ring-fencing was first proposed, the UK banking sector landscape has changed immeasurably with new players in the market including challenger banks and fintech companies, and new types of business customers that are smaller, more mobile, and more diverse in the range of services that they require.

7.96 Equally, the recent Covid-19 pandemic has demonstrated that the economy and customer needs can change overnight, and public interventions in crises need to be equally agile. The UK banking sector sits at the heart of nearly all economic activity in the UK, and equally needs to be able to adapt to respond to changing circumstances and needs.

7.97 **The recommendations are intended to provide the authorities and banks with the ability and flexibility to respond to changing circumstances over the short and long term, without the need for frequent legislative programmes.** In essence, the recommendations are aimed at being relevant to address future needs, while fixing some immediate rigidities. The authorities are best placed to assess the risks to banks, and the proposed changes should enable the authorities to make forward-looking, judgment-based decisions.

7.98 The recommendations on removing geographical restrictions from legislation, moving definitions from legislation to regulators, and reviewing the excluded activities will enable the authorities and banks to better respond to changing circumstances.

7.99 **Strategically addressing the interactions between the ring-fencing regime and resolution regime in the future should also provide for a simpler, more coherent regulatory regime for UK banks, as well as banks from other jurisdictions, to operate in.**

Annexes

Annex A: Acronyms and Glossary

FCA	Financial Conduct Authority
FPC	Financial Policy Committee
GFC	Global Financial Crisis of 2008-09
FSBRA	Financial Services (Banking Reform) Act
FSMA	Financial Services and Markets Act
MREL	Minimum requirements for own funds and eligible liabilities
NRFB	Non-ring-fenced body
PRA	Prudential Regulation Authority
RFB	Ring-fenced body
RFI	Relevant Financial Institution
SM&CR	Senior Managers and Certification Regime

Banks

Unless otherwise stated in the Report, any reference to 'banks' is intended to capture whole banking groups.

Basel regime/Basel III

'Basel III' is a comprehensive set of international reform measures, developed by the Basel Committee on Banking Supervision (BCBS), to strengthen the regulation, supervision, and risk management of the banking sector in response to the financial crisis of 2007-09.

Minimum requirements for own funds and eligible liabilities (MREL)

Debt and equity held by a bank that can be used to absorb losses and recapitalise if it were to fail, enabling it to continue operating without taxpayer bailout.

Non-ring-fenced body

A non-ring-fenced body is a legal entity within a UK banking group that is subject to the ring-fencing regime. Within the UK banking group, this is the legal entity that is not permitted to hold 'core deposits' and is where the bulk of the investment banking type activity and other restricted activities of the UK banking group must take place.

Proprietary trading

The Financial Services (Banking reform) Act 2013 defines proprietary trading as taking place "where the person trades in commodities or financial instruments as principal." This covers a wider range of trading activities including market making, trading on behalf of clients, and hedging activities.

'Classic' proprietary trading is a particular type of proprietary trading where a firm uses its own money to trade in financial instruments, speculating on future prices to make a profit.

Relevant Financial Institution (RFI)

The definition of an RFI is set out in the ring-fencing regime's secondary legislation, the EAPO. Broadly, institutions captured by this definition are banks (except for other RFBs), investment firms, large insurers, and funds such as Undertakings for Collective Investment in Transferable Securities (UCITs) and Alternative Investment Funds (AIFs).

Resolution/resolvability

Refers to the process whereby the authorities seek to manage the failure of a bank in a safe and orderly way that minimises any adverse impact on the rest of the financial system and the wider economy. Measures to improve the ease with which banks can be put into resolution – their 'resolvability' – are central to several ongoing financial regulatory reform initiatives.

Ring-fencing regime

Introduced through the FSBRA 2013 and supplemented by secondary legislation and PRA rules, ring-fencing requires the largest UK banks to separate core retail banking from services such as investment and international banking. The PRA introduced ring-fencing policy between 2014-2017, setting out requirements on structure, governance and the continuity of services and facilities. The regime came into effect in January 2019.

Ring-fenced body

A ring-fenced body is a legal entity within a UK banking group that is subject to the ring-fencing regime. Within the UK banking group, this is the legal entity that is permitted to hold 'core deposits' and is where the bulk of the retail banking activity of the UK banking group takes place.

Too-big-to-fail

Too-big-to-fail relates to the view that some banks are so instrumental due to the scale of critical services that they provide to the economy, that a disorderly failure would result in severe impacts on the financial system and economy. The only alternative is government financial support to keep such banks open to ensure continuity of these services.

Annex B: Legislative and technical aspects of the regime

Section 1: The legislative approach to the ring-fencing regime

B.1 The ring-fencing regime was established by the Financial Services (Banking Reform) Act 2013 and supplemented with secondary legislation and PRA rules, shown in Table B.1.

Table B.1: Division of ring-fencing rules across legislation and regulators

Primary legislation	Secondary legislation	PRA Rulebook
• Part 9B of the **Financial Services and Markets Act 2000** as inserted by the **Financial Services (Banking Reform) Act 2013**.	• The Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014 ("**RBCA Order**"). • The Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014 ("EAP Order"). • The Financial Services and Markets Act 2000 (Banking Reform) (Pensions) Regulations 2015.	• PRA Supervisory Statement SS8/16: Ring-fenced Bodies (RFBs). • PRA Policy Statement 10/15: The implementation of ring-fencing: legal structure, governance and the continuity of services and facilities. • PRA Policy Statement 20/16: The implementation of ring-fencing: prudential requirements, intragroup arrangements and use of financial market infrastructures. • PRA Policy Statement 3/17: The implementation of ring-fencing: reporting and residual matters.
• Amends FCA & PRA objectives. • Defines 'core activities'. • Defines 'excluded activities'. • Empowers authorities to make ring-fencing rules. • Empowers PRA with new restructuring powers. • Requires PRA to report annually to Parliament.	• Introduced £25bn 'core deposits' exemption for smaller banks. • Sets out the restrictions imposed on the RFBs. • Defines activities that RFBs cannot undertake and the type of exposures RFBs cannot have.	

Source: UK Parliament, Bank of England

Section 2: Excluded activities for a de minimis exemption

B.2 As set out in Recommendation 1, the Panel proposes a new exemption for banks that do not undertake excluded activities. In measuring these excluded activities, the Panel has set out in Table B.2 the activities that should be measured.

Table B.2: Excluded activities for a de minimis exemption

Restriction	Legislation
RFB excluded activities to be measured for use of a de minimis exemption*	
Dealing in investments as principal**	EAPO, article 4
Commodities trading	EAPO, article 5
Financial institution exposures (larger than SMEs)	EAPO, article 14
Other RFB restricted activities not to be included in a de minimis exemption	
Direct access to inter-bank payment systems	EAPO, article 13
Use of shared services of banking group	FSMA section 142H(4)(b)(ii) PRA rules Ring-Fenced Bodies, chapter 9
Intra-group distributions	PRA rules Ring-Fenced Bodies, chapter 11
Arm's length transactions with other members of its banking group	FSMA section 142H(5)(a) PRA rules Ring-Fenced Bodies, chapter 12
Income dependence on affiliates	PRA rules Ring-Fenced Bodies, chapter 13
Netting arrangements for RFB and affiliates	PRA rules Ring-Fenced Bodies, chapter 14
Shared collateral with affiliates	PRA rules Ring-Fenced Bodies, chapter 15
Pension arrangements restrictions	FSMA (Banking Reform) (Pensions) Regulations 2015 and section 142W, FSMA

* The Panel has assumed that recommendations relating to RFI SME exemptions and the removal of geographical restrictions from legislation are taken forward, and so are not included in this list. If those recommendations are rejected, the Panel would expect both activities to be considered part of the RFB excluded activities to be measured for use of a de minimis exemption.

** RFBs already have exemptions in legislation for some activities under the 'Dealing in investments as principal' category, such as simple derivatives. These activities are not intended to be captured here.

Section 3: Issues relating to definitions

B.3 Stakeholders provided submissions on a wide range of issues related to the technical aspects of ring-fencing rules. Alongside recommendation 4, which proposes changes to what the Panel judges as priority issues, the Panel also notes for completeness the following wider list relating to legal definitions that industry raised.

B.4 The Panel considers it appropriate that when the legislation is amended to take forward this Review's recommendations, the authorities should also review this wider list of definitions that may create ambiguity.

Table B.3: Technical definitions in the ring-fencing regime

Issue	Description
Definition of "structured finance vehicle" and associated exemptions	A "structured finance vehicle" (SFV) is a type of relevant financial institution (RFI), and RFBs are normally unable to incur exposures to RFIs. There are, however, exemptions for SFVs which are sponsored by the RFB. The definition of SFV and the rules relating to the exemptions are potentially unclear and complex. There may also be some unintended consequences in the drafting – so that, for example, the exemption for sponsored SFVs applies in respect of assets originated by the RFB or its subsidiaries but not in respect of assets issued by another ring-fenced body in the same group.
Definition of "related undertakings"	An RFB is allowed to undertake certain activities that would otherwise be prohibited when it does so for the benefit of a subsidiary undertaking or a "related undertaking" – which is defined as a subsidiary undertaking of a parent undertaking that is subject to the group ring-fencing rules. The current definitions would not, however, allow such activities to be undertaken in respect of an entity in which the RFB had only a "participating interest" (which normally means an interest of between 20% and 50%). If an RFB had an interest in a 50/50 joint venture entity, for example, it could not undertake the prohibited activities for that entity. The ring-fencing rules allow RFBs to acquire a participating interest in companies. It is potentially confusing to not permit RFBs to undertake activities in respect of those companies that it can undertake for its subsidiaries and related undertakings.

Definitions of “qualifying organisations” and “qualifying groups” for NRFBs	A deposit held for the account of a “qualifying organisation” or a member of a “qualifying group” is not a core deposit within the meaning of the ring-fencing legislation – which means that the entity holding such a deposit does need to be an RFB. However, some potential problems with the definitions have been identified: • *Meeting qualifying condition thresholds on a prospective basis:* In order to be a “qualifying organisation” or member of a “qualifying group”, a customer is required to satisfy certain financial tests. These tests are based on its current and historic financial condition with no regard given to its financial projections. • *Charitable trusts, companies, and associations:* Charitable trusts, companies, and associations that have been established by a group that is eligible to be banked with the NRFB, will, in many circumstances, not qualify as members of that group within the meaning of the test for qualifying organisations. Such entities can become ‘orphaned’ from the rest of their group, who are banking with the NRFB.
Definition of “correspondent banking”	RFBs are not permitted to incur exposures to RFIs, but this is subject to exceptions. There is an exception for exposures arising from the provision of money transmission, including “correspondent banking”. Correspondent banking is defined as an arrangement between two credit institutions pursuant to which one such entity provides payment services to the clients of the other entity, on its behalf. A number of concerns have been expressed about this definition including that: correspondent banking arrangements may involve more than two credit institutions; the entities involved may not always be “credit institutions” i.e. deposit-taking banks; services are not always provided directly to the client; and the services do not always constitute money transmission.

Exemption for conduit vehicles	An RFB may incur an exposure to an RFI in respect of loans to certain conduit vehicles. There are two types of conduit lending arrangement contemplated by the rules, but there are some differences in how they are treated. The following concerns were expressed: • so-called "D" conduit vehicles (as defined in Article 17(2)) of the EAPO) have been included in the scope of the exemptions for RFI exposures in Articles 6(1) and 7(1) of the EAPO but in respect of the exemption in Article 7(2) for sponsored SFVs; and, in the absence of an exemption from Article 7(2) for an RFB acquiring a relevant instrument from a conduit vehicle/D vehicle (as defined in Article 17(2) and as contemplated by Article 17(2)(b)), the excluded activity may operate to restrict certain otherwise permitted connections/ exposures to relevant conduit vehicles/D vehicles. • so-called "A" conduit vehicles (as defined in Article 17(1) of the EAPO) are not included within the exemptions in Articles 6(1) and 7(1) in the same manner as "D" vehicles. The justification for these distinctions is not immediately apparent. In addition, it is unclear how the exemption applies in the context of warehouse securitisations, as the securitisation vehicle typically issues funds to fund its acquisition of the assets and it may not be possible to regard this an "incidental activity" which would allow the vehicle to remain within the exemption.
Status of ownership interests in LLPs and collective investment schemes	It is not clear if RFBs can acquire capital interests in limited liability partnerships (LLPs) and collective investment schemes, as the current exemptions which allows RFBs to deal in investments are stated only to apply to shares or debentures, and not to ownership interests (such as a participation in a partnership) that do not come within that description.
Liquid assets	An RFB may incur an exposure to an RFI if the purpose of the transaction giving rise to the exposure is to allow the RFB to hold liquid assets in order to meet the liquidity coverage requirement in the Capital Requirements Regulation. As drafted, this provision can be read as not allowing the RFB to use the exemption to hold liquid assets in excess of the minimum required under the liquidity coverage requirement. Such an interpretation would render it very difficult for an RFB to actually rely on the exemption, which would defeat its purpose.
Default risk exemption	Under the general exceptions, an RFB can carry out an excluded activity if the main purpose is to limit the extent to which it, or other entities related to it, will be adversely impacted by several factors. One of these factors is an exemption for default risk. However, it is unclear whether this exemption applies in respect of guarantees (or similar) taken from an RFI to secure lending by the RFB to a non-RFI client.

Definition of “Core services”	The ring-fencing regime applies to banks that carry out the “core activity” of accepting retail deposits. Another term, “core services”, is used in the regime to inform the statutory objectives of the PRA and FCA in relation to RFBs. “Core services” means accepting deposits, payment services, and overdraft facilities. Both the PRA and FCA have a statutory objective to ensure that the business of RFBs is carried on in such a way as to avoid an adverse impact on the continuity of the provision of these “core services”. This definition is broader than the “core activity” provision, which is the basis on which banks are brought within scope of the ring-fencing regime. It is potentially unclear whether “core services” is intended to cover the activities of non-banks who might be involved in these services - for example: (i) platforms operated by NRFBs, or non-banks, through which deposits may be made with RFBs; or (ii) the activities of payment services institutions that are not banks.
Definition of “exposure” and the related concept of when an exposure is “incurred”	An RFB is prohibited from incurring exposures to RFIs. There is, however, still some uncertainty around the meaning of the terms “exposure” and “incurred”. For example, the term “exposure” uses the definition from the Capital Requirements Regulation but it is not clear whether an exposure is still prohibited if the exposure is valued at zero under that Regulation.
Account holder	The question of whether an account contains a “core deposit” (which is used to calculate the £25bn threshold to determine whether a bank is within scope of the ring-fencing regime) depends on the nature of the account holder. There still remain some uncertainties around the status of certain types of account holder – particularly where there is a separation of the legal and beneficial ownership of a deposit (as you might have, for example, where a trustee holds a deposit for the benefit of a trust beneficiary).

Section 4: Potential unintended consequences

B.5 The Panel received submissions that some areas of the regime are potentially giving rise to unintended consequences. As with the list in Section 3, these submissions are included to provide the authorities with a complete list of potential issues they should be aware of when re-drafting legislative provisions.

Table B.4: Other issues raised by stakeholders

Issue	Description
Shared Services	An RFB cannot receive services or access facilities from a group member outside the ring-fence unless that member is a dedicated group services entity. There is no materiality element in the rule, so it potentially applies to any service or facility, even if the service or facility is insignificant. Some stakeholders suggested that the ring-fencing regime imposes an unnecessary cost burden as the RFB cannot make use of group services infrastructure.
Liquidity management for ring-fenced bodies	RFBs are permitted to deal in investments as principal provided the “sole or main purpose” of the transaction is to limit the extent to which “liquidity risk” adversely affects the RFB. There are potentially legal uncertainties and ambiguities in relation to this provision. These arise because the scope of the “liquidity risk” exemption is difficult to apply in practice and, if narrow interpretations are adopted, the meaning becomes potentially constraining. In particular: 1) it may be unclear whether specific individual transactions undertaken as part of a broader liquidity management policy would meet the “sole or main purpose” test; and 2) the requirement for the liquidity risk to affect the RFB itself is considered overly restrictive and does not allow the bank to take other steps that would support the bank’s wider economic health.
Tax exposures	Taxes imposed in the UK are imposed primarily on particular legal entities rather than on groups as a whole: as a result, an RFB should not have a legal obligation in respect of any UK tax exposures of an NRFB in its group. However, in some instances the tax rules may impose a secondary liability for the unpaid UK tax of an NRFB on an RFB. Such scenarios appear to be unlikely in practice but would be potentially problematic if they did arise.
Annual audit requirements	The provisions on Arm’s Length Policy seem to indicate that annual audits are necessary to monitor compliance. However, no material non-compliance has been discovered by previous audits suggesting this is potentially disproportionate.
Ring-fencing transfer schemes	An RFB may transfer business to an NRFB in its group through a ring-fencing transfer scheme (a particular type of court-sanctioned transfer). It is however unclear whether a RFB can transfer only a part of a relationship with a particular customer to its NRFB and leave the other part in its RFB.

Section 5: Excluded activities and prohibitions

B.6 The Panel received submissions from stakeholders that the excluded activities that an RFB is restricted from carrying out can cause complexity and result in undesirable outcomes for customers. As per recommendation 6, the authorities should review these activities and consider whether it is appropriate to allow these activities in an RFB. Special consideration should be given to financial stability implications, and potential benefit to customers, when assessing these activities.

Table B.5: Excluded activities raised by stakeholders

Issue	Description
Debt for equity swaps	RFBs are normally prevented from "dealing" in investments such as shares, which can limit RFBs' ability to take equity participations in other entities. There is an exception under the ring-fencing regime which allows RFBs to engage in "debt for equity swaps" – i.e. under which the RFB will accept equity in a company in return for releasing the company from a debt it owes to the RFB (or to an affiliate of the RFB). Respondents have commented that the exception is too narrowly drawn. In particular, the need for the equity stake to be in direct exchange for debt write-off has meant that RFBs are sometimes unable to support complex restructurings where – for example - an equity stake is taken outside of debt forgiveness. Respondents have also asked for clarity on certain aspects of the "debt for equity swap" exception, including in relation to the ability of the RFB to purchase warrants relating to the relevant company's shares before the restructuring actually takes place.
Strategic investments via equity stakes	The restriction on RFBs dealing in investments can prevent them from taking strategic stakes (i.e. stakes below 20%) in other companies – e.g. individually in companies such as FinTech's, or through investments into undertakings such as the Business Growth Fund or Big Society Capital.
Divesting	Although the ring-fencing regime provides for several exceptional situations in which an RFB is allowed to acquire shares and debentures, the RFB is more limited in its capacity to sell or divest them. This can lead to situations where an RFB has to hold an investment for the long-term, regardless of market developments and whether that investment continues to meet the RFB's changing risk appetite.
Share-dealing errors and failures	Although an RFB is allowed to offer securities dealing services to its customers (under which the RFB passes orders to brokers or deals as agent for its customers), an RFB faces an additional practical obstacle that does not apply to NRFBs or banks outside the ring-fencing regime that offer similar services. It is typical for a securities broker to be able to step into a transaction in place of one of the participants in order to correct an error or rescue a trade that would otherwise fail. An RFB cannot do this, however, as this would be considered dealing as principal.
Test trades	The restriction on dealing as principal means that RFBs are prevented from undertaking live test trades (even for a nominal amount) when releasing new products or new technology for services.

Emissions allowances	The restriction on dealing as principal applies to all forms of securities and derivatives. The definition of "securities" under the restriction is broad enough to cover emissions allowances, which prevents RFBs from dealing in relation to them. There are exemptions to the restrictions on dealing in securities, but those exemptions use a different definition and so the exemptions do not apply to emissions allowances. Similarly, the list of derivatives-related activities that RFBs are allowed to engage in are not defined broadly enough to cover hedging in relation to emissions allowances.
Acting as trustee	There are exceptions that allow RFBs to carry out dealing as principal or to incur financial institution exposures when they do so as trustee on behalf of individuals or charities. It is not clear why this should be limited only to individuals and charities. The exemptions also omitted to include references to nominees in Scotland.
Project finance (inflation swaps)	An RFB is not able to deal in derivatives unless an exemption applies. There are exemptions for currency swaps and interest rate swaps but not for inflation swaps. Project finance transactions typically use inflation swaps in relation to long-term hedging. As an RFB cannot enter into such swaps, it would have to get the NRFB from its banking group involved in the transaction. This creates friction for the banks and their customers.
Mortality risk	The exceptions for dealing as principal do not allow an RFB to hedge mortality risk. This affects RFBs' ability to offer lifetime mortgages.
Trade finance exemptions	One of the exemptions to the RFI rule is aimed at exposures that arise in the context of trade finance. However, there are still uncertainties regarding the scope of the exemption. For example, one of the requirements is that the agreement in question specifies the goods or services to which the RFB's transaction relates. There are common forms of arrangement that support trade finance but do not specify the goods or services - such as standby letters of credit - and the effect of the rule is to prohibit such transactions for RFBs.

Annex C: The ring-fencing regime's governance arrangements

C.1 The independence of RFBs was a key element of the ICB's recommendations and is central to maintaining the ring-fence. RFBs are required to make decisions independently of their group and are subject to requirements regarding Board composition, committees, remuneration, risk management, internal audit resources and conflicts. The governance requirements for RFBs are contained within the PRA Rulebook.

C.2 Submissions were received stating that the ring-fencing regime's governance requirements are overly complex, burdensome, create legal conflicts, and go beyond what is necessary to support the objectives of the regime. The issues raised were carefully considered and assessed. The following outlines issues regarding the independence of RFBs, the regime's broader governance requirements, and interactions with the SM&CR.

The independence of RFBs

C.3 The PRA is required to make rules for 'group ring-fencing purposes', with one such purpose being that an RFB must be "able to take decisions independently of other members of its group".[1] The governance rules for RFBs contain additional requirements which aim to support specific ring-fencing requirements and in particular to ensure that the board of an RFB is able, where appropriate, to take decisions independently in support of ring-fencing requirements.[2]

C.4 The ICB considered that independent governance is considered necessary in order for RFBs to be able to:

i) enforce the ring-fencing rules that require them to have restricted / limited relationships with other group companies, which in turn are necessary in order for the RFB to have economic independence; and

ii) indirectly consolidate the foundations for a corporate culture of long-term customer-orientated UK retail banking.[3]

C.5 Respondents to the Review's Call for Evidence raised concerns that certain corporate law rules prevent an RFB that forms part of a larger group from acting independently from its parent or its wider group, thereby creating a conflict with ring-fencing governance requirements.

C.6 A board should act in the interests of the company which, in normal circumstances means the interests of shareholders. This means taking decisions in furtherance, for example, of group strategies and risk appetite as well as taking into account the shareholders' commercial interests. Instructions from shareholders should normally be acted on by a board.

C.7 The question arises as to whether there could be a conflict between the duties to a shareholder and to comply with regulation such that a board of an RFB is unable to act independently in accordance with the RFB requirements.

1. *S.142H(1) and (4) FSMA. This is also set out in rule 3.1 of the Ring-Fenced Bodies Part of the PRA Rulebook. Accordingly, this rule is enforceable by the PRA – see paragraph 3.6 of Consultation Paper 19/14.*
2. *PRA, Policy Statement 10/15, paragraph 3.2.*
3. *ICB, September 2011, Final Report, page 15.*

C.8 The PRA has made clear in its guidance that it expects accountability to parent shareholders to continue to be the baseline for RFBs, but that it expects RFBs to deviate from shareholder instructions if necessary in order to comply with ring-fencing requirements.

"It is important to emphasise that where an RFB forms part of a wider group it will remain a subsidiary, and therefore the parent company will still be expected to exercise adequate oversight of the RFB in an appropriate manner consistent with governance good practice. However, parent company actions should not cause an RFB to act in a way that is inconsistent with the ring-fencing obligations.

The PRA would typically expect to see RFBs adopt group policies, with the RFB board and management reviewing these against the ring-fencing obligations and objectives, and making additions or adopting more restrictive policies in line with those obligations and objectives only where necessary".

C.9 Respondents to the Call for Evidence expressed views that the requirement for independence goes beyond that necessary to support the ring-fence. Additionally, some perceive there to be practical difficulties in balancing the principle of independent decision making with the need to support its parent shareholder given that the RFB's sustainability remains dependent on decisions taken outside of the RFB subgroup.

C.10 However, as set out, the PRA has made clear that RFBs are not expected to be independent in all respects. RFBs are expected to comply with parent instructions, except where those instructions have the potential to lead to a breach of the ring-fencing rules, in which case the RFB comply with the rules.

C.11 Additionally, a banking group within the ring-fencing regime could not realistically make an argument that acting in breach of legal or regulatory requirements is in the best interests of the RFB. Not only might the company incur and suffer fines, claims, and reputational damage for regulatory failures, ultimately it could lose its PRA authorisation and be unable to continue doing business. The board of the RFB is therefore likely to want to comply with the law. In most situations, such compliance will be consistent with the interests of the wider banking group as well.

C.12 If a parent company instructed its subsidiary to act in a way that amounted to a breach of law (e.g., by instructing it to give consumers limited information, so that it would be difficult for them to switch products or providers), the subsidiary would be in breach of relevant rules if it followed those instructions. The board of the subsidiary would instead have to comply with the law rather than the instruction. If they failed to do so, they would risk sanctions and penalties as well as the possibility of removal from the board by a regulator. In the case of an RFB, where the breach related to ring-fencing requirements, the wider banking group itself would face possible "electrification" of the ring-fence. Individuals on the board and within the wider group who are covered by the SM&CR would also be potentially subject to penalties. Finally, if a shareholder persisted in instructing a subsidiary to breach law or regulation, it may no longer be regarded by the PRA as fit and proper to be a controller of a regulated entity.

C.13 The net effect is that there will normally be a commonality of interest between a parent and a subsidiary in relation to the latter's compliance with the law. Where there is not, there is likely to be significant pressure to resolve the situation amicably in order to avoid negative publicity and regulatory scrutiny of both the board of the RFB and the parent. Tensions do arise from time to time between a parent and a subsidiary, including in relation to the obligation to comply with the law. These need to be managed, whether the issue relates to ring-fencing rules or otherwise, and especially when the parent is not itself regulated in the UK. In the case of ring-fencing, these should be managed in accordance with the PRA's guidance, as previously described.

The ring-fencing regime's governance requirements

C.14 Responding to the Call for Evidence, stakeholders indicated that the ring-fencing regime's governance requirements were stricter than other governance rules, burdensome, and disproportionate. Examples are explored further.

Different individuals have to sit on the boards of various group entities and there can be difficulties in recruiting directors at the holding company level because the role is non-substantial or duplicative.

C.15 The ring-fencing governance requirements were compared to the following governance rules:

Table C.1: Governance rules

Rules	Entities within scope of rules
PRA Rulebook	Banks, insurers, and systemically important investment firms
Companies Act (CA 2006)	Companies as defined under s.1 of the CA 2006 (includes listed/ unlisted/private and public companies)
UK Corporate Governance Code (the Code)	Premium listed companies
Wates Corporate Governance Principles	Large private companies

C.16 It is largely the case that the ring-fencing rules replicate, rather than go beyond, existing guidance or best practice that is set out in PRA guidance or the Code. For example, one stakeholder suggested "the requirement for half the Board and Chair to be independent [under the ring-fencing rules] is stricter than the corporate governance code". Section 2, provision 11 of the Code states that "at least half the board, excluding the chair, should be non-executive directors whom the board considers to be independent governance code". This mirrors the requirement under the ring-fencing rules.

C.17 It could be argued that the ring-fencing rules are unnecessary if they largely replicate existing guidance and best practice. However, if the ring-fencing rules were to be removed, RFBs would only be subject to:

- general PRA and CA 2006 governance rules, which do not contain prescriptive requirements on e.g., board composition; and
- general PRA guidance on corporate governance best practice. The PRA would not be able to take enforcement action in relation to 'contraventions' of such guidance.

C.18 The Code would apply to a listed parent company but not to an RFB (unless it was also listed). The ring-fencing rules therefore are simply an application of existing best practice.

C.19 The absence of the ring-fencing governance rules could, if an RFB chooses not to adopt 'best practice', have the effect of removing the mechanisms by which RFBs are able to enforce other ring-fencing requirements, namely by removing its ability to take decisions independently of its parent company. Therefore, there is merit in these requirements remaining 'codified' in the PRA Rules. This allows the PRA to take appropriate enforcement action for breaches of those rules. Similarly, the PRA has expressly highlighted that it has "sought to make proposals for new rules only where it considers existing rules to be insufficient".

C.20 Some stakeholders argued that the consequences of the ring-fencing regime are disproportionate, particularly where there is a high degree of alignment between the RFB and the group.

C.21 Having separate membership of all boards is no doubt more burdensome and costly. However, this is a natural cost of ring-fencing and is required to achieve sufficient independence of RFBs. There is merit in certain directors focussing only on the interests of the RFB so as to avoid a temptation to take competing group interests into account.

C.22 The PRA is able to and has issued a number of waivers and modifications in relation to the governance of RFBs, where those rules have been determined to be "unduly burdensome" or where they do not achieve the ring-fencing purposes.

Board and committees of the RFB and holding company in a group operate concurrently, each of which must have separate agendas and minutes.

C.23 The need to have separate board meetings is not a specific requirement under the ring-fencing regime. This stems from a need for directors to demonstrate that they are acting in the interests of the specific legal entity and are managing / avoiding conflicts of interest. This is a general expectation applicable to other banks and financial institutions.

Difficulty in continuing cross-utilisation of resources to gain efficiencies from global initiatives and group expertise.

C.24 Beyond the restrictions on RFBs actually receiving services and facilities from other group entities and certain intra-group transactions, the Panel does not consider that the ring-fencing governance rules prohibit RFBs from participating in group initiatives and benefiting from group expertise. The PRA has expressly clarified that the requirement for an RFB to be able to take decisions independently does not mean that an RFB's policies are required to be at odds with those of the wider group. The PRA would typically expect to see RFBs adopt group policies, with the RFB board and management reviewing these against the ring-fencing obligations and objectives, and making additions or adopting more restrictive policies in line with those obligations and objectives only where necessary.

C.25 Moreover, whilst an executive's primary responsibility is to the RFB, there is nothing to preclude that executive from exercising 'dotted-line' reporting to, for example, an individual exercising the role of a country head. This would only become problematic if that relationship became one of reliance on the country head such that the board of the RFB could no longer exercise independent decision making.

Difficulty in having to comply with a wide range of rules such as the ring-fencing regime, the EU rules and group requirements.

C.26 The Panel is not aware of any specific conflicts with EU law, not least because UK banks were directly subject to it previously. Specifically, the requirement for parent company oversight over subsidiaries under EU law derives from the EBA Guidelines on internal governance under Directive 2013/36/EU. These guidelines applied to UK entities prior to the UK's departure from the EU (including when ring-fencing rules were in force), and pursuant to PRA guidance, continue to apply to the extent they remain relevant.[4] The Panel is not of the view that 'effective management and oversight of the risks of the group' by parents is diminished by subsidiaries' independent decision-making in relation to the ring-fencing rules. This is as compliance with those rules seeks to reduce the RFB's risk, which ultimately benefits the parent. In a similar vein, the obligation to exercise effective management and oversight is not an obligation to direct subsidiaries.

4. *PRA, 2019. Interpretation of EU Guidelines and Recommendations: Bank of England and PRA approach after the UK's withdrawal from the EU.*

Ring-fencing and the SM&CR

C.27 The interaction between the ring-fencing regime's governance requirements and SM&CR were also considered.

C.28 The SM&CR imposes obligations and responsibilities upon certain senior individuals within a firm. Given that the SM&CR holds individuals to account for ensuring that the business of the firm for which they are responsible is controlled effectively and in accordance with relevant regulations, the question arises as to whether the ring-fencing governance regime is unnecessary to protect the ring-fence.

C.29 However, the aims and objectives of the two regimes are different. In particular:

i) The aim of the SM&CR relates to individual accountability. In contrast, the governance requirements of the ring-fencing regime have an entity focus - i.e. establishing and maintaining a ring-fence around certain banks and ensuring that those banks act independently to the extent required.

ii) The contents of the rules within the separate regimes are different. The SM&CR requires firms to map certain roles and functions to relevant individuals. However, the SM&CR does not contain rules on board composition, committees, remuneration, risk management, internal audit resources, or conflicts of interest. These have all been identified as key elements in supporting an RFB's ability to be independent.

C.30 It should also be noted that most of the SM&CR is not new. In many respects, the SM&CR regime for senior managers is the same as the "approved persons" regime that preceded it.

C.31 On the issue of maintaining independence given the requirement for group-level executives and non-executives to be senior managers of RFBs, the Panel concluded that this does not have an adverse impact on an RFB's independent decision-making ability. The Group Entity Senior Manager's obligation under the SM&CR is to ensure that the RFB is complying with ring-fencing rules rather than to issue the RFB any instructions in respect of commercial interests. On the contrary, it would seem helpful in ensuring that the group understands the obligations to which RFBs are subject to and therefore help ensure an alignment of interests.

C.32 In the main, the SM&CR permits enforcement against individuals whereas the ring-fencing regime permits enforcement against entities.

C.33 The Panel concluded that the ring-fencing regime's governance requirements reflect best practices and regimes in place elsewhere and does not see the need to propose any changes. Furthermore, the PRA can grant waivers in relation to its Rulebook to modify the requirements for those firms for whom all the governance requirements may not be necessary. The PRA has sufficient flexibility to modify the rules for individual firms on a case-by-case basis and has actively granted such waivers.

Annex D: Background to the resolution regime

D.1 A bank resolution is the process by which the authorities can intervene to manage the failure of a bank in a manner other than allowing it to go into simple insolvency. The Bank of England, as the UK resolution authority, is tasked with managing bank failure in pursuit of its statutory resolution objectives. These include protecting and enhancing the stability of the UK financial system, ensuring the continuity of banking services and critical functions, and protecting public funds. The resolution powers and tools are set out in the Banking Act 2009.

D.2 The Bank of England may only place a firm into resolution when a number of statutory conditions are met. For example, the bank must be 'failing or likely to fail', and it is not reasonably likely that action can or will be taken to change this. Bank resolution is also only used if it is in the public interest. If the public interest test is not met, banks may be placed instead into the relevant statutory insolvency regime. If resolution tools are used (e.g. bail-in, partial-transfer), three broad phases follow this decision:

- **Stabilisation phase:** Once the conditions for resolution have been met and the resolution authority has employed one or more of the resolution tools, the first step is to stabilise the bank so that it can continue to provide all of its critical banking services ("critical functions") and most or all of its other banking services. Stabilisation of banks inside the ring-fencing regime is expected to be achieved through a bail-in that restores the solvency of the failed bank. In a bail-in, the claims of shareholders can be written down and the value of the claims of certain unsecured creditors can be written down or converted into equity to recapitalise the bank. This phase is sometimes referred to as the "resolution weekend", as it is expected to occur when markets are closed, usually over a weekend.
- **Restructuring phase:** In a bail-in, once the bank has been stabilised the next stage is to consider what restructuring is required to address the causes of failure and restore its viability. The extent of restructuring needed will depend on the causes of failure. This phase is likely to take at least a few months.
- **Exit from resolution**: Occurs when the Bank of England's implementation of resolution has been completed. Any further restructuring is carried out by the bank's board and management according to the new business plan.

Resolution planning

D.3 The Bank of England maintains a resolution plan for each bank operating in the UK, setting out its preferred resolution strategy, and assesses annually if there are any factors that could prevent the Bank of England from implementing it. For most banks in the UK, the Bank of England's preferred resolution strategy is a modified form of insolvency. That means their preferred resolution strategy does not envisage the use of resolution stabilisation powers. The potential barriers to resolvability are generally far fewer for banks for which insolvency is the preferred resolution strategy.

D.4. On the other hand, banks whose preferred resolution strategies involve the use of stabilisation powers (see Table D1) have far more work to do before they can be considered resolvable. The firms in table D.1 are within the scope of the Bank of England's Resolvability Assessment Framework (RAF). The RAF places the responsibility on banks to demonstrate both to the Bank of England and publicly their preparedness for resolution and that they have identified the risks to a successful resolution. To be resolvable, the firms in the scope of the stabilisation powers must, at a minimum, be able to achieve three resolvability outcomes:

- Have adequate financial resources in the context of resolution.
- Be able to continue to do business through resolution and restructuring.
- Be able to coordinate and communicate effectively within the firm and with the authorities and markets so that resolution and subsequent restructuring are orderly.

D.5 The ring-fencing regime applies only to a number of firms in Table D.1. Therefore, the regime cannot be a prerequisite for achieving resolvability, as most firms have to achieve it whilst not being subject to the regime.

Table D.1: UK banks and building societies whose resolution strategies involve the use of stabilisation powers

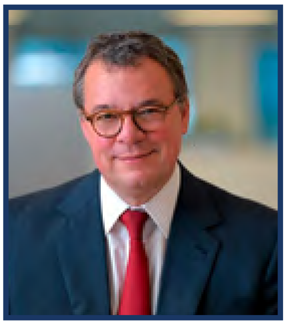
Banks	Building societies
• Barclays	• Coventry Building Society
• HSBC	• Leeds Building Society
• Lloyds Banking Group	• Nationwide Building Society
• Metro Bank	• Skipton Building Society
• Monzo Bank	• Yorkshire Building Society
• NatWest Group	
• OSB Group	
• Santander UK	
• Standard Chartered	
• Starling Bank	
• The Co-operative Bank	
• Virgin Money	

D.6 For more information about the Bank of England's approach to resolution, readers may wish to refer to the 'Bank of England's approach to resolution' and statement of policy 'The Bank of England's Approach to Assessing Resolvability'. Annex 1 of the statement of policy includes a stylised resolution timeline.

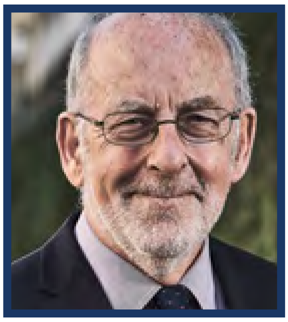
Annex E: RFPT Review Panel and Secretariat

RFPT Review Panel[5]

Keith Skeoch – Chair



Patrick Honohan



John Flint

Betsy Nelson

Preben Prebensen

Linda Yueh

RFPT Review Secretariat

The RFPT Review Panel was supported by a Secretariat of officials drawn from the public sector:

Kripali Manek (Head of the Secretariat); Laila Ahmed; Olga Dimitrescu; Diana Earle; Alexander Eisner; Rob Elliot; Kemal Ercevik; Salvatore Ferrara; Precious Oladipo; Josh Phillips; Samantha Small; and Yuriy Volvyn.

Other colleagues involved in earlier stages of the Review were: Barney Greenish; Ashleigh Hanna; and Nick Seaford.

5. *Further details on Panel members are available at https://rfpt.independent-review.uk/people John Flint stepped down from the Panel in September 2021 ahead of his taking up the role of Chief Executive of the UK Infrastructure Bank.*