



BANK OF ENGLAND

Speech

From Construction to Maintenance: Patrolling the ring-fence

Speech given by

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Introduction

It is a great pleasure to be here again at the Cass Business School, and I am very grateful to the Associate Dean for inviting me. In fact, Andrew and I have quite a lot in common. We share a birthday, for a start, and a home county (Hampshire). For a while, we also used to share an office, back in the far off days before the financial crisis, when – as young(ish) economists – we used to debate the relevance of the ‘corporate veil’ for determining macroeconomic outcomes. Nowadays, we don’t discuss the corporate veil so much as the banking ring-fence, and that is the focus of my speech tonight.

A decade on from the financial crisis, one of the largest ever reforms to the structure of the UK banking industry is coming into force. By 1 January 2019, the largest UK banking groups must have implemented the ‘ring-fencing’ – or separation – of their UK retail business from their international and investment banking operations. This means that the core banking services on which retail and small business customers depend should not be threatened should things go wrong in wholesale financial markets or the global economy.

We do not expect most people to notice significant change day-to-day once the new regime goes live. But should we experience again the sort of threats to the financial system we saw during the crisis, ring-fencing will help ensure banking groups are easier to sort out if they get into trouble, and can fail with less impact on the economy and taxpayers.

Banks have now largely completed the ring-fencing of their retail operations, and have done so with little disruption to their customers and counterparties. The PRA’s supervisory focus will turn to ensuring the ring-fences that have been established are effective in practice, and remain so. Ring-fencing both broadens the range of regulatory requirements, and increases the intensity of supervision, for the groups in scope. As such, ring-fencing will remain a focus for the PRA – as well as for the banks themselves – in the coming years.

How will the next crisis be different?

Financial crises generate significant and persistent costs. The Bank of England has estimated that the costs of crises amount to 75% of GDP on average.¹ The previous crisis resulted in the Government providing £65 billion of capital to RBS and Lloyds to prevent them failing and disrupting the provision of vital banking services to their customers. Since then, a comprehensive regulatory reform package was developed – which in large part has now been implemented – to reduce the likelihood that such a crisis could happen again.

¹ Brazier, A., (2016), ‘A macroprudential approach to bank capital: Serving the real economy in good times and bad’, speech available at <https://www.bankofengland.co.uk/speech/2016/a-macroprudential-approach-to-bank-capital-serving-the-real-economy-in-good-times-and-bad>.

In 2010 the Government established the Independent Commission on Banking (ICB) to make recommendations to improve financial stability and competition in the banking sector. The ICB recommended that the core retail banking operations of UK banking groups should be ring-fenced from any international or investment banking activity in their groups. The ICB argued that if retail banking operations had been ring-fenced prior to the crisis, this would have reduced the likelihood that the banks would have needed Government support.

The ICB's recommendations formed the basis of the banking reform legislation passed by Parliament in 2013. This set out the core banking activities which must sit in a ring-fenced bank, as well as the 'prohibited' activities that must be separated from the ring-fenced bank or stopped altogether. The legislation also specified the degree of separation required. Ring-fenced banks must have the capability to make decisions independently of their groups and should not be operationally dependent on group entities which undertake prohibited activities. Ring-fenced banks must also have sufficient financial independence and have their own capital and liquid resources. Any exposures to the rest of the group must be limited and on commercial terms.

All large UK banking groups – defined as those with 'core' retail deposits greater than £25 billion – are required to implement ring-fencing by 2019. Currently, seven banking groups cross this threshold. Between them, these groups have around £5 trillion of assets, both in the UK and overseas.

The ring-fencing regime is designed to be consistent with the other parts of the post-crisis regulatory framework. The most systemically-important ring-fenced banks will be held to higher capital requirements. The Systemic Risk Buffer will be applied to ring-fenced banks to ensure they are adequately capitalised and resilient to shocks. We expect ring-fenced banks to have, on average, around 1.5 percentage points more high-quality 'Tier 1' capital than non-systematically important banks.² And a ring-fenced bank will not be able to be capitalised by debt raised externally by its group, which would give rise to so-called 'double leverage'. Overall, the Bank estimates that ring-fenced banks' total loss absorbency will be, on average, around 27% of their risk-weighted assets, higher than the 17% recommended by the ICB.³

Ring-fencing also helps improve the resolvability of the big UK banking groups. The resolution strategy for groups including ring-fenced banks will typically involve a bail-in at the level of the holding company. Bail-in would recapitalise the relevant entity by passing losses up to the holding company to be borne by shareholders and debt-holders. This should stabilise the group. Structural separation then provides authorities with additional options as part of any subsequent restructuring.

Ring-fencing, together with other elements of the post-crisis regulatory landscape, means that the key providers of important retail banking services are less likely to fail following a shock to the economy or the

² See Bank of England (2018), *Financial Stability Report*, June, page 44.

³ See Bank of England (2016), *The FPC's framework for the systemic risk buffer*, May, Box 2.

financial system. But if banks do get into trouble, there will be greater certainty that important banking services will continue to be provided without disrupting customers and without the need for Government bail-outs. This is the key difference ring-fencing delivers should we experience a repeat of the financial crisis.

What changes are happening?

To comply with the legislation, each banking group has had to restructure to ensure that their new ring-fenced banks can meet prudential requirements on a standalone basis, have their own governance arrangements and have viable business models.

In some cases, a banking group's ring-fenced bank has been established as a brand new legal entity. Setting up a bank from scratch is a considerable undertaking, even more so for a bank which will have millions of customers from day one. In fact, last year the PRA authorised the three largest new banks ever established in the UK. And by the end of this year, we will have assessed and approved more than 50 applications for senior management positions within these groups, and considered the suitability of their proposed prudential sub-groups, containing hundreds of entities between them. Ring-fencing also resulted in the Bank helping ring-fenced banks undertake around 20 on-boarding operations to payment systems settling across the books of the Bank, and admitting six banks to the Sterling Monetary Framework.

Most of the banks have also needed to undertake a complex legal process – called a ring-fencing transfer scheme – to transfer assets and liabilities between legal entities in their group.⁴ Each transfer required Court approval. Independent 'skilled persons' were required to review the banks' plans, the PRA and FCA were called to provide their opinions, and objections from the public were invited before the judges could make their decisions. In each case, the Courts were able to approve the transfers going ahead.

These transfers took place between April and August this year. Over £800 billion of assets were moved between legal entities over a series of implementation weekends. Operational changes, in particular involving IT systems, can be complex, and the impacts when things go wrong can be wide-ranging and difficult to remedy. But in each case the ring-fencing transfer took place smoothly.

A knock-on impact of these transfers was that the sort codes of over 1.3 million retail and corporate account holders needed to be changed. To make these changes the banks put in place programmes to re-allocate accounts to the right side of their ring-fences in a way which minimised disruption for customers. These changes are all but complete, and have taken place without most account holders needing to take any action themselves.

⁴ These legal processes were considered sufficiently important that they were included in a list compiled by *The Lawyer* of the twenty biggest and most interesting court cases to follow in 2018.

While the change that ring-fencing brings about is substantial for the banking sector, it has been implemented – as intended – with little impact on the public. And when the regime goes live in January, the majority of the banks' customers and counterparties should notice little substantive difference to the services they receive day-to-day.

How will the banks operate from 2019?

But what changes will be happening within the banking system? Ring-fencing will change how banking groups are structured and how they are managed. Ring-fencing will also influence the evolution of the industry as a whole.

The legislation specifies the activities that must be conducted by ring-fenced banks, as well as the activities they are prohibited from undertaking. Any activities falling outside those two categories – for example taking deposits from large corporates, or mortgage and credit card lending – can sit either side of the ring-fence in the new group structures. This has afforded banking groups some discretion when deciding how to comply with ring-fencing requirements, reflecting their current operations and preferred business strategies. Some groups have restructured so that the vast majority of their business will sit within their ring-fence, with only a small amount of prohibited activity sitting outside (a 'wide' ring-fenced bank). Others have chosen to place as much activity outside their ring-fence as the legislative requirements allow (a 'narrow' ring-fenced bank). The PRA's rules have been designed to ensure the objectives of ring-fencing can be achieved irrespective of the banks' choices in this regard.

A key aspect of ring-fencing is ensuring that ring-fenced banks have the ability to make decisions independent of their wider groups, and this forms a core part of the PRA's ring-fencing rules and our supervisory agenda. The ring-fenced bank's own interests must not be compromised for the sake of those of the wider group. Ring-fenced banks' boards should have a majority of independent non-executive directors, one of which should be the chair. And no more than a third of the board should sit on the boards of other group entities.

But the PRA's approach is proportionate to the risks posed by the firm's governance structure. If, for example, a firm has a very 'wide' ring-fenced bank, with just a small amount of prohibited activity remaining outside of its ring-fence, it is unlikely that entities outside the ring-fence could exert undue influence over the ring-fenced bank.

In such a scenario, the outcomes that the PRA is seeking could be delivered through less onerous governance arrangements than specified precisely by the rules, and the PRA has been willing to consider more proportionate solutions. A bank may apply for a waiver or modification in respect of a PRA rule, so long as it can demonstrate that complying with the rule would be unduly burdensome, or would not achieve the

purpose for which the rule was made. What the PRA has sought from a firm applying for a rule modification is that its governance arrangements allow it the means to identify conflicts of interests between the ring-fenced bank and the broader group, and that it has the ability for the former to act independently should such a conflict occur.

Flexibility around ring-fenced banks' governance was envisaged by the ICB. In its final report, the ICB stated that "the appropriate degree of independence depends upon the proportion of the banking group's assets which are outside the ring-fenced-bank. Specifically, some degree of flexibility might be appropriate where a ring-fenced bank forms a very large part of the overall group."⁵

The process of granting or refusing applications for waivers and modifications is now all but complete, and rule waivers and modifications will be published by the PRA in the Financial Services Register when the regime goes live in 2019. Governance waivers and modifications granted by the PRA will be time-limited, and the PRA will pay close attention to whether governance arrangements work as intended in practice.

As well as changing the structure and governance of the banking groups in scope of the new regime, ring-fencing will influence the evolution of the sector as a whole. From January, ring-fenced banks will account for around a quarter of the assets of the UK banking sector. And around three-quarters of UK retail deposits will be placed within banking groups subject to ring-fencing (with the rest mostly held by building societies or banks that do not meet the ring-fencing threshold).

Some ring-fenced banks will be relatively well funded from retail deposits. Ring-fencing requirements mean that banking groups will not be able to rely on retail deposits to fund investment banking or international activities, as they might have done in the past. Instead, this funding could be used by the ring-fenced banks to lend to UK households. If so, this could contribute to a continuation of the increased competition we have seen in the domestic mortgage market.⁶ But it might also mean a reduced supply of sterling surpluses in wholesale markets, which could put upward pressure on the price of sterling funding for banks that have relatively fewer retail deposits.

How will ring-fencing affect the business models of banks which sit outside the ring-fence in banking groups? Each of these banks has had to structure their business models to ensure that they are independently viable, and have adequate and stable funding sources. The PRA has examined the banks' financial projections, and these assessments fed into the approvals that formed part of the ring-fencing process. But banks should, as a matter of course, continue to examine carefully their viability and funding risks. For example, as part of their contingency funding planning, banks will need to consider what options are available to them to meet any unexpected outflows. These banks are able to access the full range of the Bank of England's liquidity

⁵ See Independent Commission on Banking (2011), Final Report, para 3.91.

⁶ See Bank of England (2018), *Financial Stability Report*, June, page 31.

facilities, including the Discount Window Facility, and they should consider the extent to which they have collateral that can be used to obtain liquidity should they need it.

How will we supervise the ring-fence?

The PRA's work on ring-fencing does not end with the implementation of the new regime on 1 January. From this date the PRA's focus moves from putting up fences to ensuring they remain fit for purpose.

From 2019 the PRA has a statutory objective to ensure that ring-fenced banks do not threaten the continuous provision of core retail banking services. When drafting this objective, the Government was clear that maintaining core services should be a central pillar of the PRA's safety and soundness objective, and not an additional obligation. This means the PRA will apply its existing supervisory approach to meeting our ring-fencing responsibilities. We will use this approach to focus on the biggest risks to ring-fenced banks and the integrity of their ring-fences.

Ring-fencing expands the scope of the requirements with which ring-fenced banks need to comply, and that the PRA needs to supervise. But it would be a mistake to believe that the aim of ring-fencing was to create 'bullet-proof' banks to which the PRA could apply a lighter-touch model of supervision. Ring-fenced banks – like all financial firms – will take risks, and those risks need to be managed and mitigated by the banks.

The PRA's risk-based approach to supervision also means that the PRA will continue to focus on those banks which pose the greatest risks to the financial system. This would include banks which sit outside of the ring-fences of banking groups where they are important providers of critical economic functions such as lending to large corporates or intermediating in financial markets.

And ring-fencing has brought about the creation of additional legal entities within our banking groups which will need to be supervised and meet prudential requirements on an individual basis. Previously, a universal bank could carry out all of its activities within a single legal entity, and face one set of prudential requirements. After separating its retail activity in a ring-fenced bank, the group will need to meet several sets of prudential requirements; those for the ring-fenced bank, those for the group and those for any entities sitting outside the ring-fence. That means the PRA needs to set requirements – covering capital, liquidity, governance, and so on – for more entities within each banking group.

More legal entities means more bank boards. The PRA will review the effectiveness of boards and how the different boards in a group interact with each other. We will supervise the transactions and interdependencies between members of the group, including any dedicated entities set up to provide services to ring-fenced banks, to ensure these are consistent with the objectives of ring-fencing.

We will be transparent in how we undertake our ring-fencing responsibilities. The PRA has recently set out its approach to supervision, including in respect of ring-fenced banks.⁷ We will also publish an annual assessment of ring-fencing. From next year, the PRA will report annually to Parliament on the steps the banks have taken to implement ring-fencing and their level of compliance. We will also assess the extent to which the new regime is meeting the aims set by Government. This complements the independent review of ring-fencing required by the legislation to be started before 2021.

While implementation has progressed smoothly, the PRA will pursue instances of non-compliance which could affect our ability to meet our objectives using the PRA's existing supervisory and enforcement tools, including those available under the Senior Managers Regime. In cases of severe non-compliance, the legislation empowers the PRA to use a group restructuring tool – known as 'electrifying' the ring-fence – which enables the PRA to require a banking group to sell its ring-fenced bank or other parts of its group, subject to Government consent. As Sam Woods, the Bank's Deputy Governor for Prudential Regulation and CEO of the PRA, said at Mansion House last month, these powers, and our ongoing supervisory activity, will help ensure the ring-fence does its job.⁸

Conclusions

In less than six weeks, ten years on from the financial crisis, one of the largest ever reforms to the structure of the UK banking industry comes into force. While most will notice little difference on day one, ring-fencing the largest UK banks has involved significant changes behind the scenes. This reform will make the provision of core banking services more resilient, and protect taxpayers from further bail outs. These are real benefits but are conditional on the ring-fence being maintained over time, meaning this will be a continuous process for both the PRA and the banks.

⁷ Prudential Regulation Authority (2018), *The PRA's approach to banking supervision*, (October), Chapter 5.

⁸ Woods, S., (2018), 'Good cop / bad cop', speech available at <https://www.bankofengland.co.uk/speech/2018/sam-woods-mansion-house-city-banquet>.