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What now?

White Paper on Banking Reform

June 2012

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Implementing ICB

The Independent Commission on Banking (ICB) recommendations have been largely accepted by the Government. This is seen by many to be a bold reform package which requires radical strategic, commercial and operational changes at banks.

The Treasury issued a White Paper on Banking Reform on 14th June 2012, as a follow-up to the Government's initial response to the ICB Recommendations. In it, reforms focus on three key pillars:

- Implementation of a retail ring-fence, with prohibited services being outside of this (e.g. proprietary trading).
- Greater loss-absorbency for ring-fenced banks – maintaining a minimum common equity capital ratio of 10%. In total, the White Paper recommends that UK head-quartered globally systemically important banks have a primary loss -absorbing capacity (PLAC) of at least 17% of Risk Weighted Assets (RWAs).
- Recommendations to improve competition in the sector – focusing on removing barriers to switching, increasing transparency and promoting a more competitive market structure.

The objective is to provide stability and resilience in the banking sector, ensure there are appropriate frameworks supporting bank resolutions if they go bust and remove implicit government guarantees.
The government and regulators have a big challenge to get a clear, concise and workable set of laws and guidance in place. The banks themselves face the massive task of implementing and complying.

The Government has taken a further step forward in implementing the recommendations of the ICB by publishing its Banking Reform White Paper. This builds on the earlier Government Response to the ICB recommendations. Banks will welcome further clarity on the direction of proposed legislation, but the White Paper highlights even further the complexity of executing all of this.

Government is succeeding in reducing the implicit guarantee

One of the main objectives of the ICB recommendations was to remove the implicit Government support provided to banks. The recommended increases to bank capital and the creation of a ring-fence around retail activities were designed to reduce the risk of bank failure and improve the resolvability of a bank in difficulty. If successful, the ICB reforms should mean that taxpayers will not be required to recapitalise banks and banks themselves will benefit far less from implicit public subsidy. Observation of the movement in the difference between sovereign credit ratings and UK bank credit ratings suggests that, in the eyes of the credit rating agencies, the UK government is being successful in reducing this support (see Page 9 of the White Paper). However, given the critical importance of the banking sector to the economy, we don't consider this implicit support will ever be eliminated. It is clear the UK is ahead of the other countries in this regard, but it is unclear whether other countries will follow, or whether UK banks will be placed at a permanent disadvantage compared to international peers.

Reforms have been moderated

The Government has made some significant adjustments to how it plans to implement the ICB reforms, most significantly in relation to allowing a more broad range of activities within the ring-fence and allowing ring fenced entities to accept business from outside the EU, however, this has been accompanied with new requirements for more robust risk management processes. Capital and loss-absorbency requirements have also been softened.

These changes build on some of the softening of the proposals in the initial Government Response, the biggest of which was the exclusion of non-EEA assets from PLAC requirements. In most cases we consider these changes to be sensible and will help to reduce unintended consequences. But the impact of the reforms will still be wide-ranging.

Regulatory overlap is clearer

The ICB recommendations overlap with a number of different pieces of both domestic and international regulatory reform, for example the Basel III capital requirements, the Volker rule, resolution and recovery plans (RRPs) and broader conduct regulation.

The White Paper has helped to focus those of the ICB reforms which are intended to promote financial stability, leaving some policy areas for other regulatory interventions. So while the ICB implementation may appear more flexible, this will merely place more emphasis on RRPs and the supervision by both the PRA and FCA.

Better international alignment

The White Paper takes a stronger European focus, stating that the geographic restrictions applicable to ring fenced banks are designed to enhance cross border retail business within the EU. This view could only rest on a belief in the strength of pan-European rules such as RRPs and possibly EU mandated retail bank structural reforms to come. We will know more when the Michel Barnier appointed and Erkki Liikanen chaired EU expert group reports towards the end of the summer.

Complexity grows as the plans become more detailed

Now that more details have been unveiled, firms are starting to see the complexity of the reforms. This is immediately apparent in assessing how the thresholds applicable to wealth customers, SMEs may change a bank's business profile, as well as the thresholds the Government has set out for the ring fence de-minimus exemption and the relaxation of certain product restrictions. While these details are welcome from a policy perspective, firms can now start to see the significant implementation and ongoing compliance challenges. The retail ring-fence, compared to the Volcker rule in the US, is more complex and wide-ranging with significant regulatory and policy implications and continued risks of unintended consequences. Moreover, whilst the details are certainly useful, there are still a number of different issues that are open for consultation in the White Paper as the Government has not been as definitive as perhaps the banks would have expected. Nonetheless, this provides an opportunity for the stakeholders to work through the necessary details with the Government.

This doesn't help to solve the current crisis

The proposals will help to reduce the probability and impact of a future financial crisis and may in certain situations, reduce the impact of bank failure on the continuity of day to day banking services. In the longer term these structural reforms are welcome, but they do not anticipate and are not designed to ensure a zero failure banking environment. We consider it more pressing at this time to focus attention on the current risks stemming from the Eurozone and weak UK economy. We therefore welcome the recently announced Bank of England expanded liquidity facilities (Extended Term Collateralised Repo facility) and George Osborne Mansion House speech (14 June) as a welcome shift in focus back to the current crisis. If the Eurozone deteriorates further, then more action will be required.

Key points from the White Paper

Scope of the ring-fence

The implementation of a retail ring-fence is not a change in itself as the Government had already signalled its intention to follow the ICB's key recommendation, considering the economic benefits outweigh the costs. However, the tone in the White Paper is slightly different and appears to leave more to regulatory supervision, rather than strict rules. Moreover, some measures appear to be less stringent – for example the 2017 deadline for legal and operational separation has been pushed back to 2019.

Many of the key details haven't changed, so the retail ring-fenced bank ("RRFB") will not be permitted to own or hold capital in a non ring-fenced entity. It cannot source payment services from a non ring-fenced bank and where a ring-fenced bank provides payment services to a non ring-fenced bank, exposures resulting from payments services to non ring-fenced banks will need to be monitored closely.

It is unclear whether earlier restrictions on RRFBs from accepting clients only from within the EU are still valid – as the paper does not make any explicit reference to those changes. However, restrictions on branches and/or sub-entities outside the EEA (that are not in line with principle and impact resolvability of banks) would suggest an EU client focus as they might lead to practical difficulties particularly around client service and local law restrictions.

Moreover, RRFBs are also prevented from choosing a law other than that of an EEA state for their major service and credit contracts.

Use of derivatives within the RRFB

The White Paper has clarified that derivatives, to a certain extent, are allowed to be held by the RRFB, allowing them to offer simple hedging products to SME customers subject to necessary safeguards.

Safeguards are extensive and yet to be finalised but they limit the risk the RRFB can hold on its books, the types of products, quality of collateral etc. Clarifications are needed, but the move should protect certain customers from losing simple access to vital banking products. (e.g. trade finance for SMEs)
From a financial stability perspective this is welcome, but following the complaints around sales of interest rate swaps the FCA will continue to scrutinise the sales of derivative based products.

Small institution exemptions

Banks with mandated deposits of less than £25bn will be exempt from ring-fence requirements, as will building societies (which will be subject to separate consideration in a forthcoming paper). This will be a welcome development for smaller financial institutions and smaller non-EEA owned banks. Larger banks may claim an unlevel playing field, but any impact will be small.

Ring fence implications

The ring-fence will lead to a costly restructuring of the businesses into two distinct entities – with associated infrastructure for supporting underlying operations (business and IT). For those banks with payments infrastructure sitting within their wholesale bank the legislation will prohibit the non ring-fenced bank providing payment services to the ring-fenced bank. Focus on clients within the EU will have significant implications for private banks who serve clients globally. Additionally, amendments to legal frameworks will influence non-EEA counterparties' willingness to do business with RRFBs.

Additionally, the role of off-shore banking (e.g. non-EEA states such as Jersey, Isle of Man and Guernsey) and ownership of pension deficits (operationally required to comply by 2025) will be relevant in terms of shaping the structure and profile of operation within the RRFB and non-ring fenced segment.

The White Paper also indicates a continuation of the trend under the Financial Services Bill to regulate parent companies more heavily. This might be considered as unnecessarily intrusive regulation and difficult to handle from a compliance perspective.

Unintended consequences remain

Further thought is required by banks and regulators on unintended consequences. Arguably the proposals go so far in segregating an RFRB from its group (by requiring intra-group transactions on an arm's length basis) that RFRB will have less access to group support when they get into difficulty. This may in fact have the effect of making it more likely a RFRB will fail rather than less so. The ICB report was clear that there were diversification benefits from universal banks, but regulators need to ensure the reforms don't leaf to the diversity brought from universal banks.

Consideration will still be required for impact on other types of banking clients who might be viewed as needing more protection - e.g. pension funds, retail investment funds, insurance companies – who may have to bank outside the ring-fence.

Wealth management /HNW and SMEs

High Net Worth clients, defined as individuals with between £250,000 and £750,000 of free and investible assets within a single bank, and SME clients (exceeding the threshold of £25.9m) are exempt from placing their deposits inside a ring fenced bank but will be given the choice to opt in or out. However, banks will need to monitor individual circumstances to review whether customers fall in or out of mandated services and act accordingly to either offer the choice to leave or remain in the ring fenced bank. Non ring-fenced banks will face a significant challenge in monitoring their clients to make sure they are not providing services to clients that should be within an RRFB (e.g. how do they track when a HNW becomes insolvent?).

Banks will be required to have dynamic systems and monitoring processes in place to demonstrate that they have highlighted the risks of placing money outside the ring fence.

Combined with the implementation of the Retail Distribution Review (due 1st Jan 2013), this will lead to natural reshaping of wealth service provision across different market segments.

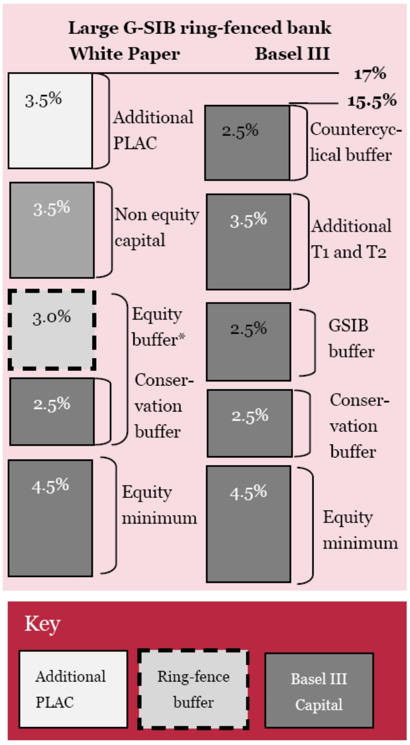
It is also important to note that there may be an interaction between the ring fencing regime and the regime for client money segregation (for example where brokers and wealth managers are required to segregate client money into separate bank accounts). Further consideration is needed here.

Capital requirements

There have not been any significant changes to the capital requirements, except for a total Primary Loss Absorbing Capacity ("PLAC") requirement of 17% (capital plus other bail-in instruments) in relation to RWAs being chosen as a minimum – rather than the discretionary range of 17% - 20%, although supervisors still have discretion to require individual banks to hold additional capital.

UK banks currently hold sufficient equity capital above 10%, but this minimum level will become much tougher as the Basel III capital rules are implemented.

The equity component can vary between 10% and 12.5% depending on whether a counter-cyclical buffer is applied, i.e., the 17% is not regarded as a hard minimum that would trigger resolution.



*Note that the equity buffer would be additional to the optional Basel III counter-cyclical buffer but not the GSIB buffer. GSIB buffer presented at maximum of possible range.

Bail-in debt

The bigger question is how banks will meet the additional 7% PLAC requirement, the details for which are still unclear, but the Government have signalled they expect to implement bail-debt through transposition of the EU Resolution Regime Directive. Key issues remain, such as whether long-term unsecured debt can be subordinated to other unsecured liabilities, and the need to ensure tax-deductibility of interest on bail-in debt instruments.

As we set out in a separate paper on this topic, there are doubts as to whether there will be sufficient market demand for these instruments.

(*The trillion dollar question: can bail-in capital bail out the banking industry?*).

Leverage ratio

ICB recommendation of a 4.06% leverage ratio has been dropped in favour of the 3% Basel III cap.

Bank balance sheets in aggregate currently provide significant regulatory headroom in relation to the 3% requirement (but on a Basel II basis) and deleveraging trends will push the backstop further away.

For most banks, the minimum capital ratio against RWA will be the key solvency instrument.

Depositor preference

Mandated deposits within the ring-fence up to £85k threshold of the Financial Services Compensation Scheme (FSCS) will rank ahead of equity and unsecured debt.

The implied additional risk for wholesale funding will increase cost of funds from capital markets. Estimates have ranged from an increase of c. 50 – 100 basis points (when combined with removal of implicit Government guarantees).

Cost benefit analysis

The ICB White Paper has quoted annual incremental economic benefit of up to £9.5bn. However, this is only realised when future banking crises are averted.

Projected transition costs of £2.5bn across the industry appear to be manageable by the banks based on current financial performance. However, the ongoing costs (including funding) of £4- £7bn will have significant impact on profitability. There is also uncertainty surrounding the future tax costs as it is unclear how issues such as VAT groupings will be dealt with and implemented.

While the cost would appear to fall most on the wholesale bank (where funding costs will be greater), ultimately this will fall on bank customers, either through more restrictive credit availability or higher credit pricing.

Moreover, the regulatory cost to support supernational organisations, such as FSB, faced by HM Treasury will now also need to be borne by the banking industry.

Account switching

Whilst the focus has remained on the 7 day requirement for current account switching to bolster competition, the Government has also included ISAs in the framework and would consider full account number portability for current accounts if switching did not improve.

As opposed to a potential Competition Commission inquiry on such practices, the Government has proposed to legislate in some other way and to 'hold the banking industry to account' to ensure improvement. As such, this is a high profile milestone that banks must deliver on, but we don't expect account switching to rise significantly because of the low economic incentives to switch.

Banking models

The Bank of England and FCA will conduct detailed reviews of market competitiveness and barriers to entry to support competition. In essence, this might bring the free banking model to an end, which is currently being welcomed by both banks and the Bank of England. Our research *Digital Tipping Point* showed that there was a willingness to pay for banking services, but if there is a move to charging for current accounts banks will need tone their services to those where there is highest willingness to pay.

Transparency

To further competition between retail banking providers, the Government is reviewing a variety of measures to enhance transparency and hence competition, many of which are based around data transparency – such as making bank account usage data available electronically so it can be easily entered into price comparison sites, including forgone interest and other relevant data in statements and annual summaries and allowing benchmarking through product standardisation.

Transparency of charges incurred and services received is a theme running across regulatory initiatives (including the need to treat customers fairly). This means banks will need to have in place much better systems to record activities and associated costs. Historically this has been done piecemeal for individual services under regulatory scrutiny (e.g. unauthorised overdraft charges), but increasingly a holistic approach will be required.

What now

Given the scope and impact of the reform package, there are a number of considerations the banks should be assessing now:

Firms need to engage now

The banks need to involve teams across the organisation to ensure they are starting to understand the strategic and operational implications, and how the reforms will impact individual business units.

There is an opportunity for further consultation

Firms may provide comments on the proposals until 6 September 2012. The fact that not all ICB proposals have been accepted (e.g. allowing some derivatives and market risk inside the ring-fence), shows that the Government is listening to banks and the specific implications of these changes. There is also a need to engage and seek specific responses covering particular areas such as tax and pensions to reduce uncertainty in areas which will be critical to structural and financing decisions.

Recovery and Resolution Planning (RRP) is essential

The retail ring-fenced bank (RRFB) will still be exposed to credit risk, interest rate risk and liquidity risk. Despite the package of structural, capital and governance reforms banks can still fail. It is likely that activities outside the ring-fence will become more exposed to failure, which is why Recovery and Resolution Planning (RRP) is still essential.

The White Paper is less directive on meeting resolvability requirements, because the earlier suggestion of essential operational services being provided by bankruptcy-remote subsidiaries is not in the White Paper. The onus seems to fall on regulators to require firms to make structural and/or operational changes where continuous provision of essential services could be a barrier to separation. This further elevates the importance of RRPs.

This is one piece of a very complicated jigsaw

The regulatory environment is changing at a rapid rate. While the ICB proposals are a significant aspect of this, other new regulations (we have counted over 100) all need to be considered in parallel.

The additional time allowed to implement the ICB plans should be used to coordinate with the implementation of wider regulatory reforms.

Responses need to be centrally-managed, with a robust and long-term governance structure

Given the far-reaching commercial consequences of these changes, it is essential that banks establish a central governance function to monitor and manage this programme of complex change. These reforms will take considerable time to implement, so the challenge for banks is to establish a central team that will remain committed and oversee this through to completion. Successful banks will be those that are able to integrate regulatory change with ongoing business developments.

Good early decisions are key

Successful implementation will be aided by robust early decisions which set the overall direction for implementation, and limit costly rework at a later date. One key early decision is whether a "new" bank will need to be created and whether this will be the ring-fenced bank or the non-ring-fenced bank. The sooner this is known, the easier it will be to build an implementation programme.

A key question banks should be asking is what their new structure will look like, i.e. what activities, customers and products will be inside and outside of the ring-fence in 2019. Only then can a path be drawn to this point and plans drawn up to coordinate ICB implementation with other regulatory reforms. Little immediate implementation may be required, but identification of changes with long lead times will help to smooth transition.

Impacts for banks

The changes that will come into effect will have an impact across the UK banks' operations. In the table below we set out some of the key implications of the report on both the retail ring-fenced bank (RRFB) and the investment bank (IB):

Area	Description	Impact inside retail ring-fence	Impact outside retail ring-fence
Competitive environment	Economic independence of retail ring-fence. LBG divestiture to create challenger bank. Current account redirection service. Enhanced regulation of Payments Council and inter-bank payments regime. More transparency and standardisation of products to allow customers to benchmark products. De minimis exemption to allow smaller banks to remain competitive.	UK retail banking market will become gradually more competitive. Need to improve costing and activity data to allow for fair price and product transparency. Digital offering to become critical to retail bank success.	Investment banking operations of UK banks will have higher capital costs as a result of this, and will need to focus where they have a strong franchise.
Products and markets	Some products are clearly in the ring-fence (e.g. retail deposits, SME lending). For others, there is more flexibility and there will be further consultation to establish limitations. Presumption should be that services are prohibited unless it can be proved that it will not jeopardise RRFB Simple derivatives for hedging purposes are now allowed within the ring fence.	Less pressure to source deposits may soften retail deposit pricing. Cross-sell activities may be less lucrative. There will need to be a series of safeguards put in place should banks want to sell derivatives within the ring fence.	Banks will need to work through and communicate to customers in business units that straddle the ring-fence. An assessment will be needed as to whether this business line will service the RRFB on an agency basis and can do this profitably.
Regulatory capital	CoreTier 1 capital ratio should be at least 10% (T1 11.5%) in the ring-fence. The target (capital plus bail-in instruments) of 17% of RWAs is more than Basel III. The Basel III minimum is 15.5% (including counter-cyclical and GSIB buffers of 2.5% each). However, the RWAs requirement excludes non-UK operations if the foreign operations are not judged to pose a risk to UK financial stability. Pillar 2 continues to provide supervisors scope to add to the minimum.	Core Tier 1 target will get tougher as Basel III reforms are implemented. Higher equity and other loss absorbing capital will depress capital ratios and ROE, requiring bank response through deleveraging, credit pricing or cost saving.	Investment banking will require significantly more equity/bail-in instruments on stand-alone basis. Some areas of IB activity may no longer meet group return expectations. The ring-fence is likely to accelerate the streamlining of IB activities.
Funding/credit rating	Economic independence between RRFB and rest of group.	Combined with higher equity and PLAC requirements, impact on funding costs may be modest (provided bail-in proposals are workable).	Loss of implicit Government support and depositor preference will increase funding costs. Estimates range from c. 50-100 basis points.
Liquidity	RRFB and rest of group will need to separately meet FSA/Basel III liquidity requirements for liquidity coverage ratio and net stable funding	Potential for additional liquidity buffers and inability to recycle excess liquidity (from either side of the bank), which will add to overall liquidity costs and depress profitability.	

	ratio.		
Leverage	Leverage ratio requirements will be in line with Basel III at 3%.	Current headroom on a Basel II basis, which is increasing with current deleveraging trends but will decrease as Basel III is implemented.	Leverage ratio will become a more important consideration at asset class level.
Operational costs	Economic independence between RRFB and rest of group.	Modest increase in systems and duplicated infrastructure costs – more likely to be passed onto bank customers.	Further pressure on IB margins – more likely to require refocus of IB activities.
Risk and regulation	RRFB to make, on a solo basis, all disclosures required by wider corporate group.	Significant risk measurement and reporting function required inside RRFB.	Greater failure risk should increase PRA scrutiny.
Treasury	RRFBs are permitted to have their own treasury function for hedging risk, managing liquidity and raising finance (all within limits).	Separate RRFB Treasury function expected to be required to ensure self-sufficiency principles of ring-fenced entity. Government seems to be moving towards acceptance of RRFB Treasury accessing markets to hedge balance sheet risks.	IB no longer able to act as RRFB's access to wholesale markets for hedging risk except as a normal, arms length market counterparty.
Tax	RRFBs should be separate legal entities.	Potential tax costs of migration to ring-fenced structure and utilisation of any carried-forward tax losses Requirement for arm's length transfer pricing for transactions/services crossing the ring-fence and potential impact on tax grouping arrangements.	
Human resources/pensions	Need to transfer staff and address legacy pension issues.	There is a non-trivial one-off implementation requirement to migrate employee contracts and address pensions issues (but the White Paper envisages an extended implementation for allocating any pension deficit). Ongoing requirement for distinct HR function within the RRFB and HR shared service provision. There will be the need for a robust governance model and determination of the culture that will be embedded on both sides of the fence.	
Corporate Governance	The board of the RRFB should be independent (only one director can sit on boards of both parts of the bank).	Separate boards need to be established. Likely to be tensions in attitudes towards risk, culture, strategy and branding. RRFB board likely to have requirement to monitor ring fence compliance. More importantly, RRFB directors and any unregulated parent company would be subject to an "extra duty" to "protect the integrity of the ring-fence".	
Suppliers	RRFB should have continuous access to critical suppliers.	Novation and transfer of supplier contracts to new legal entities. Some economies of scale may be lost in case of separate procurement. Depositor preference increases risk for other creditors.	
Payment services and other critical infrastructure	Preserving financial stability will continue to be paramount in relation to payment networks. The RRFB should have continuous access to all of the operations (people and systems), irrespective of the financial health of the rest of the group.	The RRFB must be a member of the payments systems it uses or use another ring-fenced bank for its payments. Increased focus on making sure that UK payments networks meet the current and future needs of consumers, businesses and the wider economy.	Payment services will be provided to non ring-fenced entities on a third party basis. Operational separation may result in the non-ring-fenced part of the bank being treated in the same way as any other FI for the purposes of payment processing.
Project Governance	Banks are expected to fully comply with legislation soon after it is enacted in Parliament in 2015.	A centralised and coordinated effort from management is imminently required to ensure the entire bank is progressing towards compliance by the time legislation is introduced in 2015.	

Kevin Burrowes

Head of Banking and Capital Markets Advisory

kevin.j.burrowes@uk.pwc.com

+44 (0)20 7213 1395

Steve Davies

Consulting Leader, Retail and Commercial Banking

steve.t.davies@uk.pwc.com

+44 (0)13 1260 4129

Julian Wakeham

Consulting Leader, Capital Markets

julian.m.wakeham@uk.pwc.com

+44 (0) 20 7804 5717

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