

# Short presentation on the ICB's ring-fencing proposals

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# The ICB

- ▶ The Independent Commission on Banking (ICB), chaired by Sir John Vickers, was installed by the Chancellor of the Exchequer in June 2010 and had the mission to develop recommendations for reforms to the UK banking sector.
- ▶ The focus is on the creation of a “more *stable* and *competitive* basis for the UK banking” system.
- ▶ A final report was published in September 2011.

## Recommendations and proposals: financial stability

- ▶ The recommendations concerning *financial stability* include proposals on *loss-absorbency* (capital regulation, loss-absorbing debt, etc.) and on *ring-fencing*.
- ▶ Motivation and objectives:
  - ▶ make banks better able to absorb losses
  - ▶ reduce the likelihood of a crisis
  - ▶ assure that service provision is not interrupted in the event of a bank's failure
  - ▶ make it easier and less costly to resolve banks (ideal: a self-reliant banking system; “get taxpayers off the hook”)
  - ▶ curb incentives for excessive risk-taking

## Recommendations and proposals: financial stability (cont.)

- ▶ *Ring-fencing* addresses mainly the last three objectives!
- ▶ Other possible benefits of a *ring-fence* (according to ICB):
  - ▶ “insulate vital UK retail banking services from global financial shocks”
  - ▶ easier monitoring of ring-fenced banks and more transparency
  - ▶ “good for competitiveness because UK retail banking can be made safer”
- ▶ The ultimate aim is to design a banking system that is “effective and efficient at providing basic banking services”:
  - ▶ safeguarding retail deposits
  - ▶ operating secure payment systems
  - ▶ efficient channeling of savings to productive investments.

## What is ring-fencing? Why not go for total separation?

- ▶ *Ring-fencing* is a way to structurally separate retail banking activities from wholesale and investment bank activities.
- ▶ The ICB recommends a *strong* and *flexible ring-fence* that can provide the same stability benefits as *total separation* at a lower economic cost!
- ▶ According to the ICB, the advantage of ring-fencing (when compared to total separation) is that it:
  - ▶ preserves diversification benefits (more “efficient” use of capital, possibly lower funding costs)
  - ▶ preserves a greater degree of operational synergies
  - ▶ has less legal obstacles when compared to full separation. Moreover, it can be implemented within the current EU framework (foreign banks with UK subsidiary are included).

# Implementation - 5 Principles

- ▶ The ICB describes five key principles that define the “height” and “location” of the ring-fence:
  - ▶ Mandated services
  - ▶ Prohibited services
  - ▶ Ancillary activities
  - ▶ Legal and operational links
  - ▶ Economic links

# Mandated services (inside the fence)

- ▶ Only ring-fenced banks should be granted permission by the UK regulator to provide *mandated services*:
  - ▶ Deposit taking
  - ▶ Provision of overdrafts to individuals and SMEs
- ▶ Characteristics of *mandated services*:
  - ▶ a temporary interruption of service resulting from a bank failure has significant economic costs
  - ▶ consumers are not well equipped to plan for such interruption

## Prohibited services (outside the fence)

- ▶ Ring-fenced banks should not be allowed to provide any service:
  - ▶ which is not provided to customers within the EEA
  - ▶ which results in an exposure to a non-ring-fenced bank or non-bank financial organization (except some payment services)
  - ▶ which would result in a trading book asset (e.g. investing in stock, corporate debt securities, etc.)
  - ▶ which would result in a requirement to hold regulatory capital against market risk or counter-party credit risk (e.g. purchase or origination of derivatives)
  - ▶ which relates to secondary market activity

## Why are these services prohibited?

- ▶ They make it significantly harder and/or more costly to resolve ring-fenced banks.
- ▶ They directly increase exposure to international financial markets.
- ▶ They involve risk-taking by the ring-fenced bank.
- ▶ They are not needed to fulfill the mandated services.

## Ancillary activities

Ancillary activities are allowed to the extent that the efficient provision of the non-prohibited services requires them. For instance if these services are required to do risk-management or liquidity management.

Backstop limits on:

- ▶ wholesale funding exposure
- ▶ total exposure (secured and unsecured) to non-ring-fenced banks and financial organizations.

## Legal and operational links

- ▶ It should be easy and quick to isolate ring-fenced banks from the group without an interruption of services.
- ▶ Ring-fenced banks should be separated legal entities (no joint liability) and only own financial organizations that conduct permitted activities.

## Economic links

- ▶ The economic links to the wider corporate group should be limited.
- ▶ Regulatory requirements should be met at a solo basis.
- ▶ The ring-fenced bank should have an independent board and dividend payments to the group are subject to the financial health of the ring-fenced bank.
- ▶ A general recommendation is that the exposure of the ring-fenced bank to the group should not exceed its usual exposure to third parties.<sup>1</sup> For the secured exposure to the group the limit is double of the unsecured third party limit.
- ▶ Within the group, assets should only be sold at market value. Ring-fenced banks should not buy assets from other entities of the group unless such assets could have resulted from the provision of non-prohibited services.

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<sup>1</sup>At present, the exposure of an individual bank to a third party cannot exceed 25% of its capital resources.

# There are many issues that deserve discussion

- ▶ Which elements of ring-fencing may be most problematic to implement in practise?
  - ▶ Separating risk-management from profit-making trading activities is difficult
  - ▶ The independence of the board of the ring-fenced retail bank is hard to establish
  - ▶ ...

# Outlook

- ▶ Last year EU commissioner Michel Barnier developed plans for a committee to look (amongst other things) on the ICB's ideas on ring-fencing.
- ▶ This week the EC launched a review of its policy on bank structure.