

# A response to the HMT's Call for Evidence Aligning the ring-fencing and resolution regimes

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## 1. Introduction

- 1.1. UK Finance is the collective voice for the banking and finance industry. Representing over 300 firms, we act to enhance competitiveness, support customers, and facilitate innovation.
- 1.2. The UK financial services sector welcomes this opportunity to respond to HM Treasury (HMT)'s Call for Evidence examining the alignment between these two significant regimes, ring fencing which is specific to the UK only, and the resolution regime, a response to the last global financial crisis (GFC) in many jurisdictions.
- 1.3. As an industry, financial services contributed £173.6 billion to the UK economy, 8.3% of total economic output, in 2021. Whilst the scale and importance of the industry to the UK economy necessitates a strong, effective and independent regulatory regime, we also need regulation that is proportionate and supports both competition and innovation, thereby helping the sector to grow safely and with confidence.
- 1.4. Our members, who are impacted by the ring-fencing regime have contributed to this response. As there was no standard 'blueprint' for ring-fencing and each financial institution implemented ring fencing in the most appropriate manner for their business model, views on the costs and benefits of the regime, and how it may evolve, vary between members. This response sets out high-level observations and recommendations, with supporting rationale, from a significant majority of the relevant members. Our members will be responding bilaterally to the questions posed in the Call for Evidence.

## 2. Observations and Recommendations

- 2.1. We agree that this is the right time for HMT to reassess the need for a ring-fencing regime, reflecting all the progress since the GFC. As the Call for Evidence outlines, ring-fencing was introduced alongside a suite of other internationally driven enhancements to bank capital, and recovery and resolution planning. We consider these to have been more impactful than ring-fencing in delivering financial stability in the UK. As a result of this progress, the basic premise of the regime, that retail banking activities need to be protected from the risk of failure of the rest of the group, has been eroded as the credibility of resolution regime improves. We therefore support the HMT's initiative and the current consultation on aligning ring-fencing and resolution.
- 2.2. We believe that the ring-fencing rules could be simplified, relaxed or removed without introducing additional systemic risk. The UK financial system has so far proved resilient in recent real-life examples of stress, including the Covid-19 pandemic, Russia's invasion of Ukraine, and market turmoil relating to Silicon Valley Bank (SVB) and Credit Suisse.
- 2.3. We suggest urgent progress on the Skeoch "near term" reforms, due later this year, including lifting of the blanket geographic restrictions for ring-fenced banks (RFBs); and a simplification of Relevant

Financial Institutions (RFI) classification, including the treatment of SME RFIs, to better support these customers as they grow and evolve. In certain areas we urge HMT to go further and/or to apply the same principles more broadly in order to ease the operational burden on in-scope firms.

- 2.4. We urge HMT to carefully consider their approach to implementing the near-term recommendations to improve the operational efficiency of the ring-fence and to ensure they are simple to execute. If it is too complicated, their effect will be less beneficial. As another near-term reform, we would recommend relaxing the prohibition on shared services and provide flexibility as to whether banks are subject to Operational Continuity in Resolution (OCIR) requirements or ring-fencing requirements relating to the continuity of critical services, both of which achieve the same outcome. We support the Panel's view that current limits to accessing share services in banking groups that contain a ring-fenced entity imposes an unnecessary cost on ring-fenced banks and limits their ability to leverage their group's capabilities and better serve their customers, the UK economy and be better prepared for the future of banking.
- 2.5. In any case, aligning resolution and ring-fencing regimes will reinforce certainty and confidence in the UK regulatory environment and financial system:
- it will demonstrate the UK's confidence in its implementation of the resolution regime that was designed to end 'too big to fail' – there can be no market confidence without regulators' confidence to begin with
  - it will give a clear sign to the market that the UK is ready and expects to use the resolution regime, providing more certainty
  - It will also therefore refocus the market attention onto resolution plans, via the firms' resolution disclosures, including their post-resolution plans (rather than base their expectations on the ring-fencing option)
  - In contrast to this, maintaining a dual regime as an 'insurance policy' may misguide expectations, create a lack of clarity as to the 'primacy' of each regime and undermine the resolution regime.
- 2.6. We recommend that careful consideration be given to whether there could be discretion provided to the PRA with respect to the application of ring-fencing rules to acquisitions in circumstances where resolution actions have been taken by the Bank of England. Such discretion, or alternatively a temporary derogation from or grandfathering of the rules, would give greater certainty to the market and depositors that a successful transfer and resolution would be achieved for a deposit-taker in difficulties. We believe that this would enhance financial stability within the UK. More generally, we suggest that policymakers review the financial stability benefit of not allowing RFBs to acquire non-RFBs (NRFBs) or non-compliant businesses and support amendments to provide for an ample waiver period to become compliant post-acquisition.
- 2.7. We support a migration of the regime from being heavily legislative to a more regulatory-based approach, thereby enabling the PRA and FCA to take a more pragmatic and proportionate approach in the supervision and enforcement of arm's length, governance and reverse servicing restrictions within the ring-fencing regimes. These areas of pragmatism in relation to the ring-fencing perimeter would not lead to increased risk to safety and soundness but would be a meaningful evolution of the ring-fencing regime.

### **3. Background and Rationale**

#### **Progress on prudential, supervision, conduct and resolution regimes**

- 3.1. Since ring-fencing was announced, there has been a progressive integration of some of the conclusions of the Independent Commission of Banking (ICB) into the mainstream regulatory agenda, for example, Primary Loss Absorbing Capital (PLAC) has become Total Loss Absorbing

Capital (TLAC) in FSB terms and Minimum Required Eligible Liabilities (MREL) in the UK and the EU, leverage ratios have been introduced. But there has been little adoption of functional ring-fencing outside of the UK, although there has been an increasing tendency to geographic ring-fencing (US FBO rules and IHCs, EU rules on IPU and Art 21c).

- 3.2. Since the ring-fencing regime was conceived in 2011, there has been considerable evolution in the regulatory framework, which has been adapted in many ways to make the financial system safer and more secure. This has reduced systemic risk and, as a consequence, improved the resilience of large UK banks, greatly reducing the risk that public funds might be required for bank bail-outs. Regulators have considerably developed their supervisory approaches, with supervision now being carried out in a more open and transparent manner, with a real-time view of major decisions. Banking culture has also improved, driven in part by the introduction of the Senior Managers and Certification Regime (SM&CR), and incentive structures no longer promoting the taking of excessive risk. Post-2008 GFC improvements in financial stability cannot therefore be attributed to ring-fencing alone. The wider regulatory framework, including Basel 3.1, recovery and resolution planning (RRP), OCIR, and stress tests, address the same risks and more. Ring-fencing therefore cannot be considered in isolation.
- 3.3. At the same time, the resolution regime has developed beyond the proposals of the ICB with a real focus on operational resilience, creation of independent service companies, bail-in models, etc. The UK resolution framework has also evolved since ring fencing regime was introduced:
- It is now comprehensive thanks to the RRP regime and Resolvability Assessment Framework (RAF) and covers policy for all barriers to resolution identified by the FSB post GFC.
  - It covers the activity of the entire group i.e. ensures continuity of retail banking and non-retail-banking critical functions
  - It establishes a mechanism and process to identify and address any impediments to resolvability.
- 3.4. The first RAF/resolution plan assessments were carried out in 2022 and the major UK banks were indicated as 'resolvable' by the Bank of England (BoE) by announcing in June 2022 that "The resolvability assessments demonstrate the significant progress made by the banking industry since the global financial crisis such that "the UK has overcome the problem of 'too big to fail'". There is some work to do on improvements and enhancements to the UK resolution regime, as highlighted in the 2022 RAF publications and there may be continuing improvements, as anticipated by the regulators, and the likelihood that other events or issues that may emerge, may have an impact. Notably, none of the BoE's public statements following the first RAF assessment gave any indication that their view that the major UK banks were resolvable was in any way influenced by their compliance with the ring-fencing regime.

### **Helping resolution not improving financial stability**

- 3.5. In the context of the evolving regulatory landscape, the benefit of ring-fencing regime is largely in mitigating potential financial instability by improving the environment for the post-resolution restructuring, rather than contributing to financial stability (i.e. by preventing failure). The process of implementing ring-fencing has ensured that the major UK banks have a very detailed understanding of the business undertaken in each legal entity and the services required to support that business.
- 3.6. The benefits of ring-fencing for resolution planning have come about mainly through the gathering of such information and the simplification required by the corporate reorganisation required for its implementation. Whilst banks with simple business models may be more readily resolvable by use of a partial transfer, this benefit is questionable in the context of the major UK banks, each of which has a preferred resolution strategy of bail-in.

- 3.7. Recent events have suggested the preferred resolution strategy for many smaller UK deposit-takers may well include at least a partial transfer rather than a bank insolvency procedure. We note it is likely that UK RFBs will be best able to act as private sector purchasers and thereby support the resolution of failing deposit-taking entities. As can be seen from the recent example of SVB, the imposition of ring-fencing rules to that acquisition made that resolution more complicated, and potentially less certain.
- 3.8. The SVB and Credit Suisse 'live test cases' showcased the operation of resolution regimes in practice and, in the case of Credit Suisse, arguably demonstrated that 'ring-fencing' of business in separate legal entities does not insulate the RFB from financial instability in other parts of its group. We recognise however that the UK business of SVB was hosted in a UK bank with its own capital and liquid assets (reflecting the PRA's policy on limiting FSCS protected deposit taking activity by UK branches of third country firms) enabled the operation of resolution tools by the BoE independently of the rest of the SVB group.
- 3.9. Nevertheless, those events are a timely reminder of the importance of effective regulation to protect customers and financial stability in general, which balances protection and the ability of UK firms to compete in the UK and beyond and drive economic growth in the UK.
- 3.10. We are also unconvinced by the 'ring-fencing bonus' idea – even the authors admit that an alternative explanation is that third parties perceive ring-fenced status as a signal of an implicit guarantee, and that looks quite plausible. In any case, the 'ring-fencing bonus' observed by the study is so marginal it can be disregarded as supporting RFBs in a stress scenario.

### **Domestic and international competition and impact on the real economy**

- 3.11. Several of the Panel's recommendations could have a significant positive impact on the UK's financial stability, firms, competition, growth, and competitiveness.
- 3.12. As HMT makes recommendations in its following consultations, it will need to be aware of the implications for domestic and international competition if (a) more banks fall outside of ring-fencing if changes to the threshold are introduced, and (b) more activities can be undertaken within the ring-fence given flexibility in its formulation. At some point, the continued application will only affect a limited number of UK groups, to the detriment of their ability to support both domestic and international customers through both their RFBs and NRFBs.
- 3.13. We acknowledge the objectives of the ring-fencing regime after the global financial crisis in trying to reduce contagion risk to core financial services in the UK. But achieving this through the ring-fencing regime has come at a very high price. The ring-fencing regime:
- is costly to implement and manage,
  - has adverse impacts on affected banks' ability to grow, innovate and service certain customers like small financial institutions and fintechs,
  - hampers provision of full services to existing SME and wealth customers, and
  - has adversely impacted competition in the mortgages market, trapping liquidity in RFBs with limited ability to be utilised in an efficient way beyond the mortgage market.
- 3.14. Separately, HMT need to critically consider their objectives for the UK wholesale banking sector, given the decline created by ring-fencing and other initiatives.
- 3.15. No other jurisdiction has implemented structural separation requirements for banks, instead relying on robust resolution regimes and prudential requirements to safeguard financial stability. A UK-only ring-fencing regime is an outlier which adds little or nothing to the resolution regime for internationally

active firms. Indeed, it may undermine the credibility of group resolution if it looks as if there is a special case for certain UK operations.

3.16. Ring-fencing may also make the UK a less attractive location for international banks seeking to grow a retail business. In particular, the ring-fencing regime prevents a UK retail bank from relying on shared services from its parent – a requirement which disproportionately impacts international banks due to the nature of their global operating models.

3.17. Where a group has a UK resolution group, consideration should be given to allowing greater flexibility of financial links between any RFB and NRFBs in such groups, assuming that there remains a separation of clients and appropriate arrangements for operational continuity. This will improve financial efficiency and liquidity management within the resolution group, whilst retaining the ability to restructure the RFB post-resolution.

#### 4. Conclusion

4.1. We welcome the opportunity to respond to HMT's Call for Evidence on aligning the ring-fencing and resolution regimes. The government has been clear in its intention to make the UK the world's most innovative and competitive global financial centre and reforming the ring-fencing regime could play a crucial role in achieving that.

4.2. Although there are strong arguments that support the removal of the ring-fencing regime in the longer term, if the government is minded to keep the regime in the medium term, we believe the outcomes of ring-fencing could still be achieved with fewer negative impacts to competition and growth through modifications to the regime.

4.3. We look forward to participating in the consultation later this year regarding the implementation of the near-term measures recommended in the independent review into ring-fencing. We welcome their inclusion in the Edinburgh reforms, they should assist to correct some of the inadequacies of the regime in the short term and allow ring-fenced banks to provide services that support government objectives like international trade, competition, innovation, infrastructure and green finance as well as allowing banks to fully hedge their balance-sheet risks, aligning with the objectives of the Edinburgh reforms to allow a more efficient allocation of capital to the 'real' economy, removing costs and undue burdens in the financial services industry without removing important protections. We welcome measures to increase competition and remove unnecessary costs in support of the wider economy.

4.4. We understand that this response together with the bilateral responses from our members to this Call for Evidence will serve to inform the government's development of an initial policy position regarding the long-term future of the ring-fencing regime. We would encourage the government and regulators to weigh these responses in the overall context of a regulatory landscape which has evolved significantly since ring fencing came into operation. Despite the introduction of new capital and liquidity requirements, requirements to improve Recovery and Resolution including Operational Continuity in Resolution, the Senior Managers and Certification Regime, Operational Resilience, and the significant strength of the UK's conduct regulation environment, the ring-fencing regime has remained entirely static. As an industry, we support that this is a timely opportunity to stand back and to consider cumulative impact of all these regimes, which have been a significant factor in the strengthening of the resilience of banks and financial institutions operating in the UK.

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