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CLIENT UPDATE

FINANCIAL SERVICES (BANKING REFORM) BILL – EXPECT THE UNEXPECTED

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INTRODUCTION

The era of light-touch regulation of the "super bank" in the City of London is coming to an end. The introduction of the Financial Services (Banking Reform) Bill, (the "Banking Reform Bill") in the House of Commons on 4th February 2013 marked a significant step forward in the UK coalition government's ambitious plans for reform of the UK's banking sector. The Banking Reform Bill, which is expected to become law within the next twelve months, will deliver the most radical reform of the UK's banking sector in a generation.

IMPLEMENTING THE RECOMMENDATIONS OF THE VICKERS REPORT

By way of background, earlier this week, George Osborne, the UK's Chancellor of the Exchequer, announced far-reaching proposals for banking reform, largely based on the recommendations of the report by the Independent Commission on Banking, (the "Vickers Report" so called after Sir John Vickers, the chairman of the Independent Commission of Banking), which was published in September 2011. The Vickers Report recommended significant structural reform of the UK's banking sector together with measures designed to increase the capacity of UK banks to absorb losses.

In particular, the Vickers Report recommended that retail banking should be separated from investment banking by the use of ring-fencing. Amongst other things it also recommended that deposits which are eligible for protection under the Financial Services Compensation Scheme should be made preferential debts in the event of bank insolvency.

The government published its initial response accepting the recommendations of the Vickers Report in December 2011. A draft Banking Reform Bill, which incorporated most of these recommendations, was published in October 2012.

It is interesting to note that as recently as last summer the Chancellor of the Exchequer rejected the idea of: (i) formal ring-fencing of retail banking services from riskier banking activities; and (ii) the Treasury being empowered to break up banks that fail to respect ring-fencing arrangements.

The political winds seem to have changed direction rather dramatically since last year as demonstrated by the Chancellor's speech earlier this week in which he expressed his desire "*to channel the anger consumers feel towards the financial services sector*". Not only does the Chancellor now approve of a retail ring-fence but he also endorses the notion of an "electrified" ring-fence. The Chancellor announced that:

> *"My message to the banks is clear. If a bank flouts the rules, the regulator and the Treasury will have the power to break it up – full separation not just a ring-fence. Banks found ways to overcome and get around the rules. Greed overcame good governance. We could see that again, so we are going to arm ourselves in advance. The system is not working for consumers, so we will change it. No more rewards for failure. No more too big to fail. No more taxpayers forking out for the mistakes of others. The same rules for the banking business as any other business in a free market. Why is it that big banks can move their money around instantly but when small business wants to make a payment is takes days. There are no incentives on the big banks to deliver new and better services for users. We will make sure that new players in the market can access these systems in a fair and transparent way."*

THE BANKING REFORM BILL'S RING-FENCING AND OTHER REQUIREMENTS

At present, the Banking Reform Bill is drafted in broad brush terms. It provides a framework for reform. The detail of the proposed new arrangements is expected to be fleshed out by means of secondary legislation and rules made by the regulator.

In short, the Banking Reform Bill:

- will require UK banks to separate everyday retail banking activities from more volatile investment banking activities by introducing a ring-fence around the deposits of individuals and businesses. Banks would be expected to ring-fence their retail operations by 2019. The extent of the ring-fence will be determined by as yet unwritten secondary legislation. Consequently, at present, it is hard to predict the form it will take. However, from the various reports and consultation papers produced to date it is likely that the following banking activities will be within the ring-fence: consumer lending, trade and project finance, deposit taking from households and small and medium sized enterprises, simple derivative products as well as advising on financial products from non-ring-fenced banks. The following banking activities are likely to be outside the ring-fence, namely, services relating to secondary market activities, most trading activities carried on by investment banks and banking services to financial institutions;
- gives depositors who are protected under the Financial Services Compensation Scheme preference if a bank enters insolvency;
- gives the government the power to ensure that banks are better able to absorb losses during a crisis and ensures that the UK's new prudential regulator (the Prudential Regulation Authority which will inherit the majority of the FSA's powers in April this year) will be focussed on holding banks to account for the strength of their ring-fence. Further, following the Chancellor's speech earlier this week, it is now clear that the government will bring forward amendments to the Banking Reform Bill, in the form of proposed powers to "electrify" the ring-fence, i.e., to give the regulator the power to enforce the full separation of banks if they disregard the proposed new ring-fencing rules; and
- aims to ensure that taxpayers are never again on the hook when banks fail.

The Banking Reform Bill introduces a requirement for directors of ring-fenced entities to be approved by the regulator, i.e., become approved persons. Such persons will be subject to disciplinary action by the regulator if they have been knowingly concerned in any contravention by the ring-fenced entity of ring-fencing rules. Further, the Banking Reform Bill requires the new Prudential Regulation Authority to make an annual report on the way in which ring-fenced entities comply with the new ring-fencing provisions. The PRA will also have to report on the extent to which any guidance which it has issued in relation to ring-fencing has been complied with by ring-fenced entities.

The overall responsibility for overseeing the new regime will rest with the Bank of England under Mark Carney, its new Governor, who will take over from Sir Mervyn King, the present Governor of the Bank of England, on 1st July 2013.

THE COST OF IMPLEMENTING THE REFORMS

The implementation costs of the reforms to the UK's banking sector are expected to be in the region of £2-5bn.

REACTION FROM THE INDUSTRY AND OTHERS

The reaction from the UK's banking sector to the Banking Reform Bill has not been enthusiastic. A senior banker at Credit Suisse accused the Chancellor of the Exchequer of "playing politics with the economy" and "banker bashing" as analysts warned that the Chancellor's plans to "electrify" the regulatory ring-fence will create uncertainty and increase cost thereby making London less competitive than the rest of Europe. Senior bankers have expressed surprise at the UK's "going it alone" approach to ring-fencing in relation to the rest of Europe. This is particularly so given that, at present, the Liikanen proposals[1] for EU-wide structural reform of banking, including ring-fencing, do not appear to have led to action by other EU member states.

Anthony Browne, chief executive of the British Bankers Association said: "*The proposed reforms will create uncertainty for investors, making it more difficult for banks to raise capital which will ultimately mean that UK banks will have less money to lend to individuals and businesses. This decision will damage London's attractiveness as a global financial centre.*"

Adam Marshall, director of policy at the British Chambers of Commerce said: "*Banking reform must be considered in the context of the economy as a whole. It is vital to business that the UK banking system is safe, but the litmus test for any banking reform is whether it unwittingly creates extra barriers for firms seeking finance. The new regulations proposed in the Banking Reform Bill must be carefully designed and implemented to avoid perverse consequences. We cannot afford to see 'collateral damage' among Britain's businesses as a consequence of banking reform.*"

However, Greg Clark, the Financial Secretary to the UK's Treasury remains adamant that: "*the ring-fence will make sure banking services provided to people and businesses will continue in the event of the failure of the bank, without the taxpayer supporting it*".

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[1] The Liikanen committee, chaired by Erkki Liikanen, the governor of the Central Bank of Finland, was established by the EU Commission in 2011 to look into and deliver recommendations on EU-wide banking reform. It delivered its final report on 2nd October 2012.

Unsurprisingly, consumer pressure groups in the UK have greeted the proposed reforms with great enthusiasm.

CONCLUSION

In conclusion, the exact details of the proposed ring-fence remain to be drafted by way of secondary legislation as well as rule-making by the regulator and the Treasury. It may well be that by the time the Banking Reform Bill has been debated in Parliament it will be less potent than first impressions suggest.

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Please do not hesitate to contact us with any questions.

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