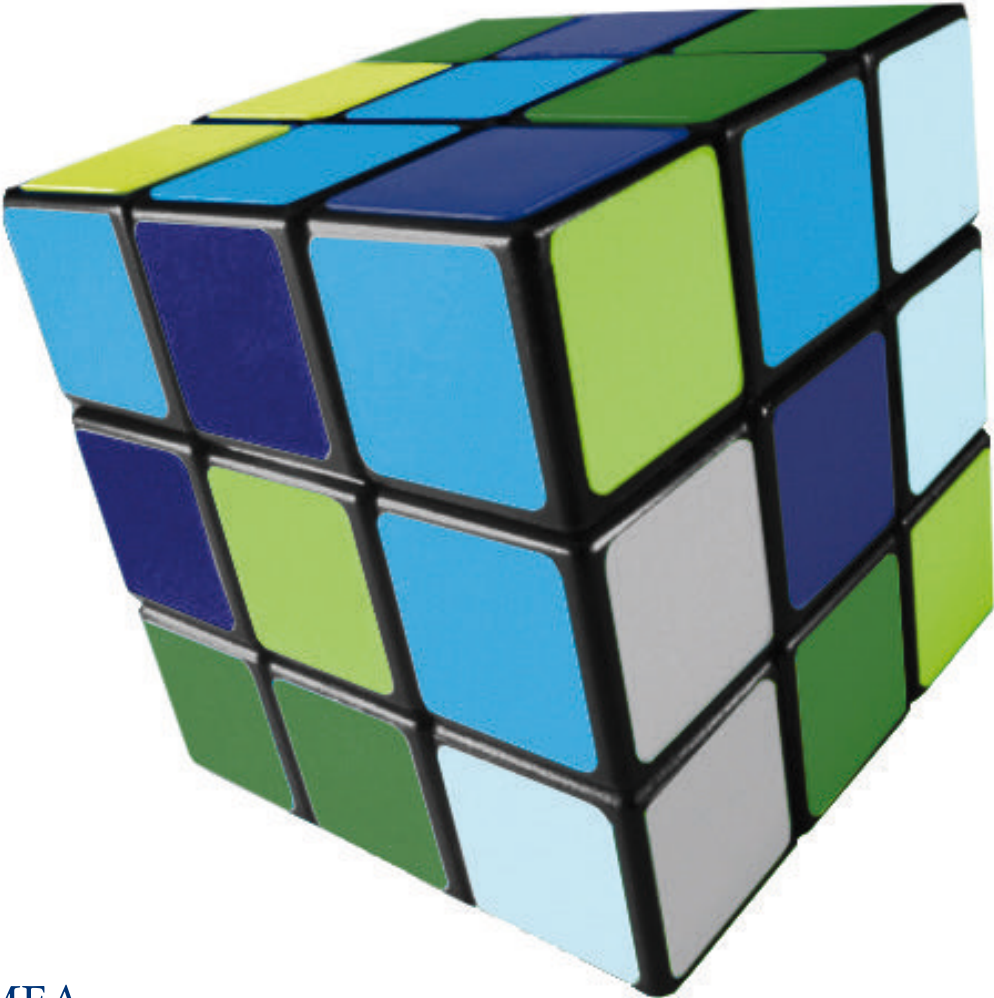


Structural reform of EU banking
Rearranging the pieces



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Executive summary

Bank structural reform proposals have multiplied across the EU in the last 12 months – legislation now exists in the UK, France, Germany, and Belgium, with the European Commission the latest authority to put forward its own proposal.

The Commission's January 2014 proposal¹ is different from existing national versions, and appears something of a hybrid. On the one hand, it would ban the largest banks operating in the EU from engaging in proprietary trading or having certain relationships with hedge funds (similar to the US Volcker rule), but would also potentially ring-fence certain trading activities, as recommended by Liikanen², while allowing countries such as the UK to pursue their own solutions (subject to certain conditions being met).

The Commission's Regulation would apply to EU-headquartered global systemically important banks (G-SIBs), and to banks (or groups including such a bank) with over €30 billion assets AND trading activities exceeding either €70 billion or 10% of assets. This also extends to branches of non-EU banks operating in the EU, although these would only be assessed on their EU activities. The first list of banks caught by the rule would be published in July 2016.

The proprietary trading ban would apply to all firms exceeding the thresholds. Additional ring-fencing would apply only to a subset and would follow an assessment of the scale and complexity of their trading activities. National regulatory authorities would retain substantial discretion in deciding on the application of the rules.

The Commission's proposal was delayed and remains at a very early legislative phase. There will be significant amounts of 'ironing out' of detail over the legislative process, which could take another 18 months.

This is to be contrasted with the various pieces of national legislation which are well on their way to completion in several countries. French banks in particular must identify the activities they must ring-fence within the next few months, with a view to separation of certain trading activities in 2015, while German banks face a 2016 deadline.

In some ways the framework is most developed in the UK, where the legislation is also furthest reaching, but timelines are longest – a 2019 implementation date.

The scale of change confronting UK banks has spurred many to engage in design and planning work already, five years ahead of this deadline. This exercise will necessarily be iterative as specific and significant details will be provided by the Prudential Regulation Authority (PRA) over the next few years. In the meantime, banks need to explore any potential optionality within the rules once they emerge, and compare different ring-fencing configurations.

This means beginning with an assessment of a bank's existing structure against the basic structural requirements of the rules, and going through a process of eliminating possible future structures which do not make business sense. Compliance with the law must be the starting point, but the various permitted optional elements in the rules means that in-depth analysis and modelling of alternatives will be necessary. It is important to recognise from the outset that ring-fencing will change cost equations (including funding costs) and relationships across the group. Taking customers along for the journey will be crucial, as will navigating the potential operational risks and legacy issues which may be uncovered along the way.

The key will be to move early but purposefully, progressing in a series of 'no regrets' steps over the whole implementation timetable, rather than opting for a single 'big bang' switchover close to the deadline date. In our view, experience in the UK to date will be both informative and instructive for banks elsewhere in the EU as they begin to come to terms with bank structural reform initiatives, either in their own country or at the EU level.

¹ European Commission, *Proposal for a Regulation of the European Parliament and of the Council on structural measures improving the resilience of EU credit institutions*, 29 January 2014, available online at <http://old.eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2014:0043:FIN:EN:PDF>

² Final Report of the High-level Expert Group on reforming the structure of the EU banking sector, Chaired by Erkki Liikanen, 2 October 2012, available online at http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf

Introduction

The biggest banks in the EU face a ban on proprietary trading and separation of their trading activities from their retail deposit-taking business under the European Commission's latest proposal to reform the structure of European banks.

The Commission's plans are an amalgam of existing initiatives. The ban on proprietary trading and investments in hedge funds is similar in intent, if not in detail, to the Volcker rule; the possibility of additional ring-fencing of trading activities is close to the recommendations of the Liikanen report; and for banks subject to ring-fencing, a series of restrictions on intra-group relationships are reminiscent of the UK's Vickers proposals. But the fact that the Commission's proposal contains elements of all three doesn't necessarily mean it is entirely consistent with them.

These sets of proposals are all part of the post-crisis attempt to solve the 'too big to fail' (or more pertinently, too big and *complex* to fail) problem, while avoiding the need for banks to split themselves up entirely, and they clearly overlap with elements of recovery and resolution planning.

But the politics of structural bank reform are complex. While regulators emphasise the resolvability benefits of certain structural reform measures, such initiatives have also become linked with moves to reduce 'excessive risk taking' and prevent retail banks from engaging in 'casino' banking activities.

Ring-fencing is therefore in some sense designed both to reduce the probability of retail bank failure, and to make it easier to deal with groups or individual entities if they do fail. Both are judged essential to underpin the smooth and sustainable flow of credit to the real economy.

The journey from pre- to post-ring-fenced banking is going to be a long and difficult one, and is only just beginning in practical terms. The scale and complexity of the challenges mean that rigorous planning is best begun as early as possible.

This paper is in two parts. In the first half we look at the details of the Commission's proposals, and compare them with the existing national frameworks across various EU countries, including in particular the UK, France, Germany and Belgium. A detailed comparative table can be found in the Appendix. In the second half of the paper we look at some of the practical consequences and challenges of ring-fencing. We focus on the details of the UK regime for this purpose – it is there where ring-fencing is most far-reaching and advanced in terms of details – although many of the lessons will apply to others subject to ring-fencing in their domestic markets.

The journey from pre- to post-ring-fenced banking is going to be a long and difficult one, and is only just beginning in practical terms.

The Commission's proposal for a Regulation

The Commission published its proposal for a Regulation on the structural reform of banking in the EU on 29 January 2014, following up on the recommendations of the High Level Expert Group, chaired by Finnish central banker Erkki Liikanen.

The Commission did not follow the Liikanen recommendations entirely, instead opting for an outright ban on proprietary trading (rather than ring-fencing it), while still maintaining the possibility of additional ring-fencing of remaining trading activities.

Scope

The Commission wants to apply its Regulation to the largest credit institutions operating in the EU, including branches of non-EU firms. This means:

- EU global systemically important banks (as defined by the revised Capital Requirements Directive (CRD IV)); and
- Credit institutions with €30 billion assets AND trading activities exceeding either €70 billion or 10% of total assets. For branches of non-EU firms, this would be applied to their EU activities only. Initially, firms would have to exceed these thresholds for three consecutive years to be subject to the Regulation.

The Commission estimates that around 30 banks would be covered by these criteria, based on historical data, and it intends to publish a list of the banks ultimately to be subject to the Regulation on the basis of more recent data in July 2016, with updates to follow annually.

The proprietary trading ban would apply to all firms exceeding the thresholds, but additional ring-fencing would only apply to a subset following an assessment of their trading activities. See Chart 1 (page 6) for a step-by-step process for determining whether an institution would be caught by the proposals.

The ban on proprietary trading and investments in funds

Banks would be prohibited from proprietary trading in financial instruments and commodities. But the proposed ban is drawn narrowly, applying to transactions which have the sole purpose of making a profit for a bank's own account without any connection to actual or anticipated client activity, performed through units specifically dedicated to proprietary trading. This is a different approach to that of the US Volcker rule, which bans proprietary trading outright even when undertaken through units which are not necessarily dedicated to that activity.

Investing in Alternative Investment Funds (AIFs) for the sole purpose of making an own account profit is also prohibited. Exemptions exist for types of funds which the Commission deems important for the financing of the economy, such as venture capital funds and social entrepreneurship funds.

Additional separation of trading activities

A subset of banks would then be subject to additional ring-fencing of trading activities, largely at the discretion of their supervisor. Supervisors would be required to assess the scale, complexity and riskiness of deposit-taking banks' trading activities using a specified set of metrics. Supervisors could require separation of any trading activities that are deemed a threat to the financial stability of the bank or the financial system, and could also require separation even if the metrics are not exceeded. However, firms would have an opportunity to respond, and if they could demonstrate to the satisfaction of the supervisor that its conclusions were not justified then the bank would not have to proceed with ring-fencing. In either case, the supervisor would have to disclose publicly its conclusions and reasoning.

Any firm subject to this additional separation requirement would face a series of further structural and operational restrictions, including:

- A requirement to be structured with two “homogeneous functional subgroups” – deposit-taking entities on one side, and trading entities on the other – with relationships at arm’s length, restrictions on shared board memberships, and a requirement for each subgroup to issue its own debt (unless separate debt issuance conflicts with the group’s resolution plan);
- The deposit-taking entity would not be allowed to own shares in the trading entity (unless the supervisor considered it to be “indispensable for the functioning of the group” and sufficient measures have been taken to mitigate the risk);
- Limitations on trading for risk management purposes, which would be restricted to management of the balance sheet risk in relation to capital, liquidity and funding. The use of derivatives for this purpose would also be restricted to certain categories which must be eligible for central clearing;
- Constraints on the provision of risk management services to customers, with the deposit taking entity permitted to sell only certain classes of derivatives, all of which must be eligible for central clearing. An aggregate position limit would apply;
- A series of large exposure limits such that the deposit taker may not have exposures of more than 25% of its capital to any other sub-group within the wider group structure; it may not have exposures to individual financial firms outside the group exceeding 25% of its capital; and it may not have aggregate exposures to financial firms exceeding 200% of its capital.

Outright prohibitions vs. optionality

For those firms to which the ring-fencing rules would apply, there are some activities which would be prohibited on one side of the divide, and some which would be prohibited on the other. Deposit-taking entities would not be allowed to carry out certain trading activities identified by their supervisors, which might include market making, complex securitisation activity and complex derivatives activities, or a broader list, depending on the way in which the supervisor exercises its discretion. The trading entities in the group would be prohibited from accepting deposits covered by an EU Deposit Guarantee Scheme (unless this related to an exchange of collateral for trading), and from providing payment services (again, unless this was ancillary to the exchange of collateral for trading).

But anything not expressly prohibited, such as mortgages, credit cards, corporate lending, and personal loans, could sit in either type of entity. While ring-fenced deposit takers may be permitted to engage in some trading and derivatives activities (again, depending on the view of the supervisor), and be allowed exposures to financial institutions up to a limit, bank executives would need to decide from which side of the fence it makes more business sense to provide these services.

Letting (some) member states go their own way – the derogation

Consistency with existing national proposals is of concern to both banks and national policymakers. The ban on proprietary trading would be mandatory across all EU countries, but when it comes to ring-fencing trading activities, the Commission proposes that it be able to grant derogation to individual member states who want to pursue their own versions, on a bank-by-bank basis.

The framing of the derogation suggests that the Commission is aiming at accommodating the UK regime, as opposed to those in France and Germany.

But derogations would not be a free for all. The Commission has said these are designed to allow member states who have already implemented “super equivalent” measures to avoid costly alignment of existing, effective provisions with its own plans. Specific conditions must be met, including that the national law hasn’t been declared incompatible with the Regulation. The effect on the internal market and single rulebook, as well as the nascent Banking Union, would also be considered. The framing of the derogation suggests that the Commission is aiming at accommodating the UK regime, as opposed to those in France and Germany.

The Commission also wants to prevent any countries without legislation already in place from using the derogation – as drafted, only legislation passed before the end of January 2014 would qualify.

Equivalence with third countries – potential exemptions

The Commission has also raised the possibility of conducting equivalence assessments with non-EU countries. Potential beneficiaries of such equivalence assessments would be non-EU subsidiaries of EU banks, and EU branches of non-EU banks, which could be exempted from the EU Regulation if a favourable equivalence assessment were conducted, although reciprocal recognition of EU rules would be required.

Timing

The Commission estimates adoption of the Regulation by June 2015, with the required additional delegated acts to be adopted by January 2016. On this timeline an initial list of covered and exempted banks would be published by July 2016, with the ban on proprietary trading effective from January 2017, and separation of trading activities by July 2018.

But for this to be possible, the proposal has to make its way through the EU legislature, and its path may well be difficult, not least because of the imminent change of the guard at the European Parliament and Commission after the summer elections, which means that real progress is unlikely before autumn 2014.

The proposal has yet to make its way through the EU legislature. Its path may well be difficult, not least because of the imminent change of the guard at the European Parliament and Commission.

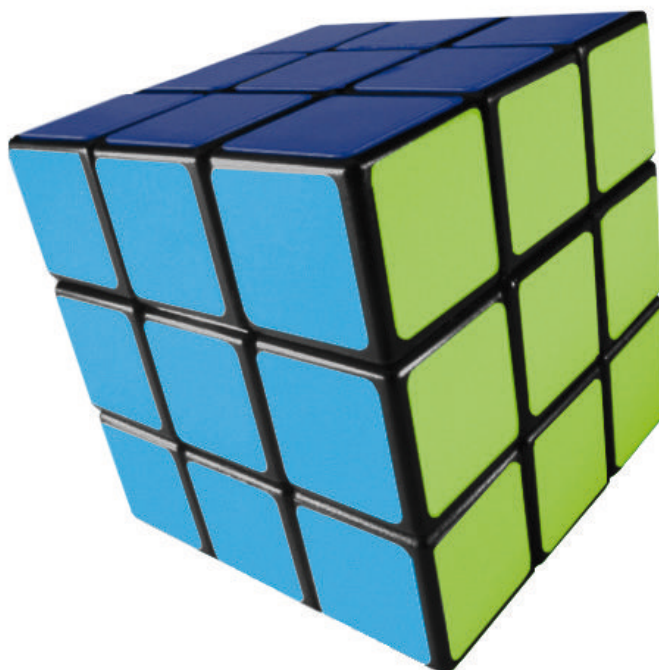
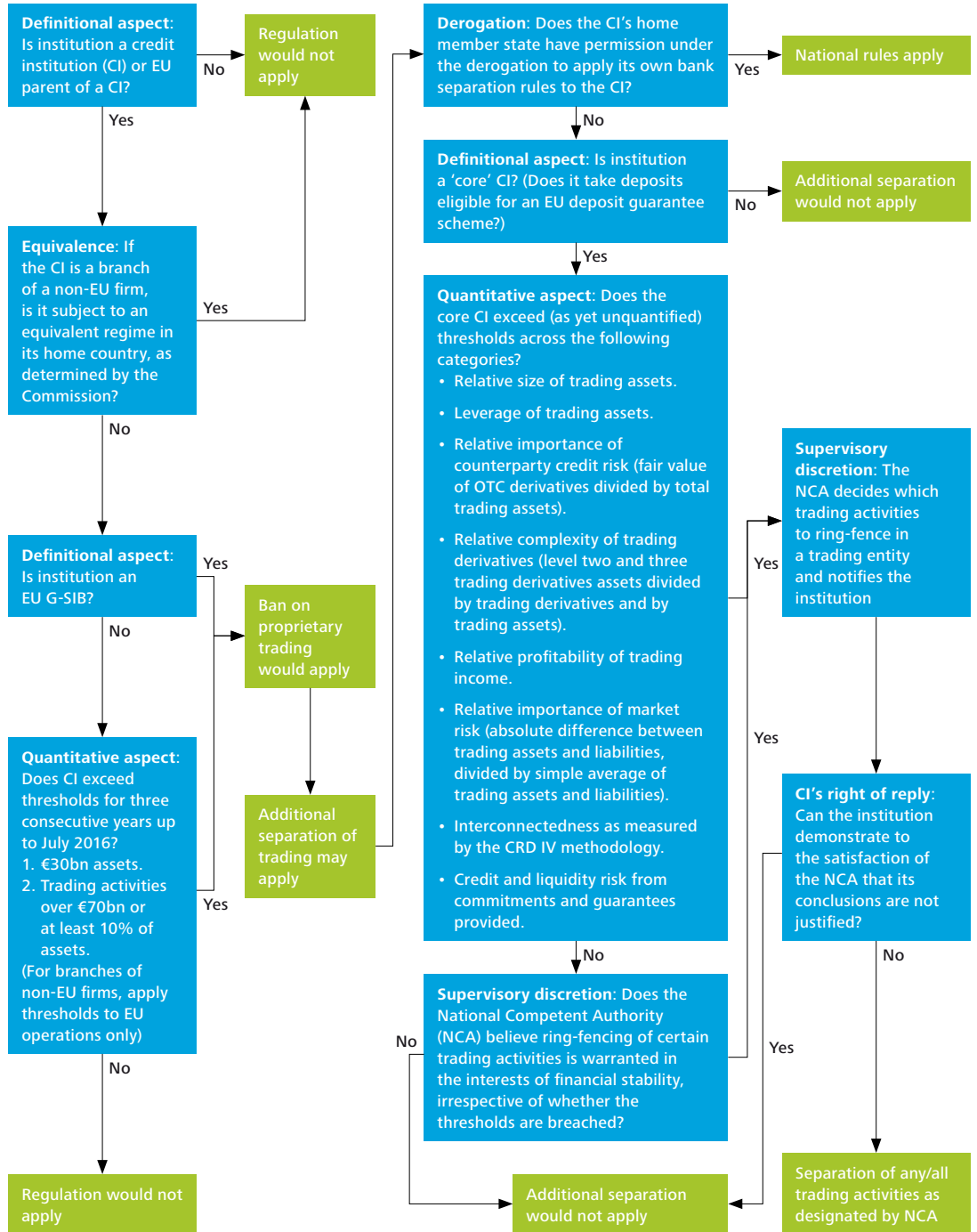


Chart 1 – Which institutions are affected?



Comparative analysis of proposals from the Commission and others

Each set of structural reform proposals is slightly different. Among them, the UK stands out for its decision to ring-fence retail banking operations, rather than trading activities. Otherwise, the effects of the proposals are similar in that all ensure that retail deposit taking activities are separated from certain classes of trading.

The UK was one of the early-adopters, with the Independent Commission on Banking (the Vickers report) in 2011 proposing structural reform, while US legislators introduced their own, very different, proposals as part of the 2010 Dodd-Frank Act. The ideas did not gain much traction elsewhere until late 2011. More recently, France and Germany have passed structural reform legislation, Belgium has proposed draft legislation, and an expert Commission in the Netherlands also recommended that structural reforms should be pursued, although as yet it has not put forward draft legislation.

While some of the high level legislation has recently been finalised, the majority of the details are still to be determined, particularly the fine-print rules which will dictate how banks actually respond. In short, a lot of rule-writing remains to be done.

Within the EU, the Commission is alone in proposing to ban proprietary trading completely for the large banks, rather than putting it into a non-retail entity. Such a prohibition would be a step further than the Liikanen group recommended. Several countries are looking to ring-fence proprietary trading, while the UK's Parliamentary Commission on Banking Standards concluded that a prohibition was not necessary at this stage.

The scope requirements are also very different in each country. The Commission's €30 billion asset threshold is the same as that used (for other purposes) in the Single Supervisory Mechanism. But its definition of 'trading activities' is not as straightforward as a measurement of trading assets or liabilities, making it difficult to assess exactly who would be caught by the proposals beyond the EU G-SIBs. The other EU countries looking to ring-fence trading activities have different, and in some cases yet to be determined, thresholds based on the size of trading activities undertaken, while the focus in the UK is on retail deposit-taking rather than the scale of trading activities, reflecting the different focus of UK legislators.

The amount of discretion afforded to supervisors adds a further element of uncertainty into the equation, particularly given that the European Central Bank (ECB) is likely to be responsible for ring-fencing decisions for any eurozone banks caught by the rules, and the ECB's views on most things supervisory are not yet widely understood, as they are still in the process of taking on these new responsibilities. If France and Germany, for instance, were granted a derogation, it is unclear whether the ECB or the national authority would be responsible for policing the national, as opposed to the EU, rules.

The Commission envisages the consolidated supervisor making a decision on the possible ring-fencing of trading activities after a quantitative assessment of trading activities. But it would also afford the supervisor the discretion to impose ring-fencing irrespective of whether the quantitative triggers are activated. The process is complicated by the fact that firms would then have an opportunity to make their case to the authorities for reversing that decision, so even within a single EU Regulation on structural reform, there is scope for very different results at different banks, particularly between countries within the eurozone and those outside.

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The run-in times for the various national proposals also vary. Ironically, it is the UK, where the lead-in time is longest, that is furthest advanced in terms of the thinking around how ring-fencing may work, perhaps because the extent of the proposed changes is much greater in the UK – that said, there are many details yet to be finalised. France and Germany – who started later – have both decided to pursue much shorter implementation timelines (French banks in particular face a mid-2014 deadline for identifying activities subject to separation), while implementation timelines for Belgium and the Netherlands remain unclear.

Table 1 in the Appendix compares the details of the various structural reform proposals, including those of the EU, UK, France, Germany, Belgium and the USA.³

³ At the time of writing, no legislation has been tabled in the Netherlands. We treat the US Volcker rule, Intermediate Holding Company requirements for foreign banks, and swaps 'push-out' rule, as a package

Design and practical challenges for firms

Whichever set of rules affects a bank, implementing a ring-fence, whether around retail operations or trading operations, is not an easy task.

Design and implementation programmes will typically be multi-year, large-scale transformation projects, creating significant upheaval in the transitional period, and with considerable operational risks.

The tasks will include designing and implementing the new legal entity structure, and the knock-on changes to governance, balance sheet structure and the operating model. Compliance with the minimum requirements of the rules is the obvious starting point, but beyond this there will be a lot of optionality, so firms will have to make choices about their business strategy. This will require attention to capital and funding issues, operational and governance issues, and of course, customer interaction.

In what follows we present a basic conceptual scheme for thinking about these issues. The process begins by taking a bank's existing business structure, assessing the minimum scale of change required for compliance, and then iterating alternative models, gradually eliminating non-compliant and non-viable options by progressively including more detail into the analysis.

Beyond compliance

The starting point must be to meet the **minimum regulatory requirements**. Each set of rules sets out some basic tenets, such as activities which are prohibited, or activities which must be separated. Comparison of a bank's existing legal entity structure and business lines against these requirements provides a starting point for the analysis.

However, beyond these minimum requirements, there is quite a lot of flexibility in terms of the remaining activities. The decision over where in the group structure to locate these will be influenced by a bank's **business model**, for instance whether it is predominantly retail or wholesale focused.

Once these issues have been considered, a series of possible structures will begin to emerge. At this point more in-depth analysis will be needed, starting with whether the options make financial sense: **modelling of the capital and funding implications** of the various asset/liability mixes in different parts of the group, and various wholesale funding options (such as holding company versus operating company debt issuance) will be crucial, particularly in relation to resolution planning. This exercise should eliminate compliant but financially non-viable options.

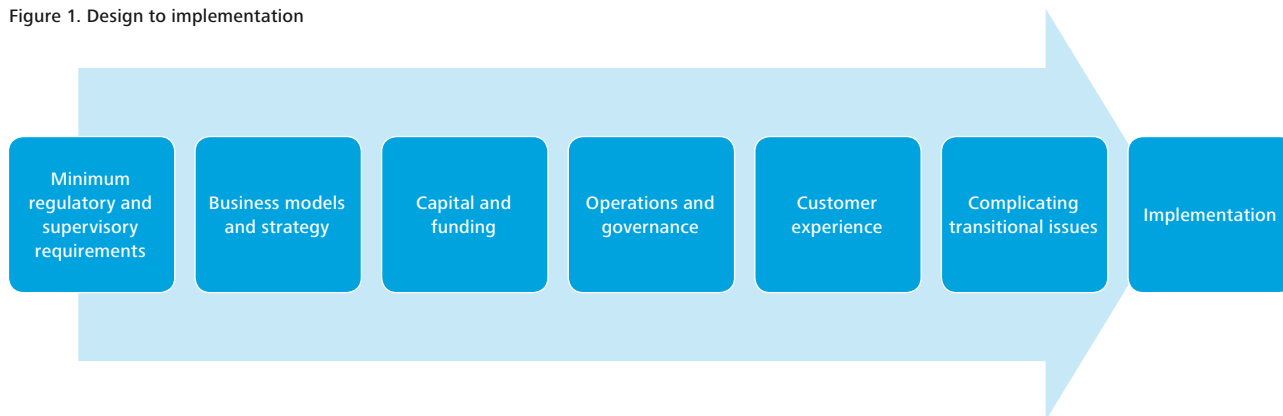
Once a set of compliant and financially viable structures has been arrived at, how should the group and individual entities be run within a given structure? i.e. what are the best **operating models and governance frameworks**, recognising that there may be restrictions on permissible models, and that operational continuity for resolution will also be crucial?

By this stage, the range of possibilities should have been narrowed to a set of compliant, financially viable, and governable structures. Then the question arises: **what does it mean for customers**, both existing and future? Structural reform on this scale cannot be a purely technical or financial puzzle – it will have implications for how customers interact with their bank, and may be disruptive if too many accounts need to be moved.

Once these issues have been considered, it will be time to dive into the detail of the bank's existing structure, and begin to unpick some of the thornier issues associated with legal entity change, particularly **hidden legacy issues** which may restrict options, and the **complications of potentially large-scale business transfers**.

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Figure 1. Design to implementation



This is a simplified schematic approach for thinking about ring-fencing. But it needs to be borne in mind that ring-fencing is not happening in isolation: it is one component of a broad regulatory reform agenda. Integration with recovery and resolution planning is clearly important given the potential overlaps, and many other regulatory requirements will be relevant, from the capital framework, to market access rules, registration requirements, and regulatory reporting. There will inevitably be a degree of regulatory uncertainty. The lingering uncertainty over where the Commission's proposals will end up does little to improve this outlook: banks may have to deal with the consequences of certain operations – such as proprietary trading – being banned outright rather than transferred to another entity within the same group.

Ring-fencing rules have not been completely finalised in any jurisdiction, but some of these major design and implementation issues can already be discerned. In the rest of this section we look at the UK regime as a case study to explore some of these issues in more depth – given that discussions of many of the important details have been under way for months. While the eventual details of the UK regime will not be identical to those imposed by regulators elsewhere, many of the lessons may also apply to others subject to ring-fencing in their domestic markets.

Some UK banks have embarked on design and transformation programmes already. In our work supporting clients in this process, we have seen first-hand the types of issues they face. A key message is that the numbers matter, but that governance, operations and customers are just as important. In what follows we identify challenges around design and delivery, and draw out transferable lessons for non-UK banks subject to ring-fencing in their home country.

The numbers matter, but governance, operations and customers are just as important.

Designing a ring-fence – what goes where?

1. Minimum regulatory requirements

In the UK, 'core' activities – essentially retail deposit-taking – must be conducted through a ring-fenced body, while 'prohibited' activities – trading as principal in investments and commodities – cannot be conducted there. All other 'permitted' activities may sit anywhere within the group. In addition, the ring-fenced bank may not operate non-EEA branches or own non-EEA subsidiaries if those subsidiaries perform activities which would be regulated if located in the UK. Banks have in the past typically co-mingled activities within legal entities, but ring-fencing changes this. Recently the UK Government also revealed that the PRA is expected to restrict permissible legal entity structures, in particular to require a "sibling" structure,⁴ whereby the ring-fenced and non-ring-fenced entities sit 'side-by-side' underneath a holding company. This requirement has its counterpart in the EU proposals with its 'homogeneous functional subgroups' requirement.

⁴ http://www.publications.parliament.uk/pa/ld201314/ldhansrd/text/131008-0001.htm#st_95

2. Business priorities – ‘permitted’ activities

There are two stylised approaches to permitted activities: a wide (maximalist) ring-fence approach, and a narrow (minimalist) ring-fence approach. A maximalist approach may remove only strictly prohibited activities from the ring-fenced entity, leaving core and all other permitted activities within it. A minimalist approach may involve retaining only strictly core activities in the ring-fence, housing all prohibited and permitted activities in a non-ring-fenced bank. Any group taking the first route will have a relatively larger share of total assets in the ‘retail’ bank than in the second option.

A bank with the bulk of its activities in UK retail banking, for example, is likely to favour the first approach, while a bank whose wholesale and investment banking activities dominate is likely to prefer the second. This is related to business models, and banks should consider at which end of this spectrum they lie in order to minimise the degree of change needed.

3. Capital and funding

Given a set of compliant and strategically consistent structures, it will then be necessary to model the financial implications of potential balance sheets, funding structures and funding mixes, credit ratings, and other issues.

Holding company vs. operating company funding structures

There are two basic options for funding structures. First, a pure holding company structure: this would see equity and wholesale funding issued from the ultimate parent company, with the proceeds downstreamed to the subsidiary banks on either side of the ring-fence. Second, an operating company funding structure: this would see both ring-fenced and non-ring-fenced entities having separate external wholesale funding lines, while equity alone is downstreamed from the parent.

In any structure, there are a wide range of factors that need to be considered:

- a) Restrictions on the way in which funding can be generated for individual entities: a ring-fenced bank may not rely on funding from the non-ring-fenced bank.
- b) Limits on cross-funding from the ring-fenced bank to the rest of the group: the extent to which the ring-fenced bank can fund the non-ring fenced bank within the large exposure limit of 25% of capital should be considered very carefully – if this option is pursued, it may act as a cap on the relative size of the non-ring-fenced entity, restricting future flexibility.
- c) Resolvability requirements: liability structures will need to enable effective resolution through an application of the bail-in tool. The introduction of the bail-in power may also make it more difficult to interpret the consequences for specific classes of creditors.
- d) Potentially tougher leverage ratio for ring-fenced entities: while this will remain speculation until the Bank of England publishes the results of its review of the leverage ratio, recent press reports suggest that a 4% leverage ratio requirement for ring-fenced banks cannot be ruled out (to date this remains a UK-specific issue).
- e) Segmentation of business across the ring-fence: funding on each side of the divide may differ and groups will have to be careful not to produce liability overhangs on the retail side (where plentiful deposit funding will need sufficient assets to fund) or a concomitant funding gap on the trading side (now starved of that retail funding).
- f) Elimination of the ‘implicit subsidy’ for ‘too big to fail’ banks: funding costs will change to reflect changed credit ratings as a result of changes to probabilities of default and loss given default expectations (assuming that orderly resolution alters recovery rates for creditors). The effects on credit ratings will be complex, and in practice there are constraints on the market’s ability to assess and price for these changes. The consequences will vary from bank to bank, and there is no substitute for detailed modelling and forecasting of impacts before deciding on the appropriate structure.
- g) Intercompany arrangements: for groups opting for holding company issuance, the possible forms of intercompany arrangements for downstreaming funding to operating entities, particularly in relation to minimising double leverage, need to be considered.

4. How will the group be serviced and governed?

Faced with a series of compliant and financially viable possibilities, the next stage is to assess possible operating models and governance structures given the independence requirements. This means, among other things, independence of decision making, operational infrastructure, risk management, and financial resources. In the UK the important qualifier is that these things must be achieved “as far as reasonably practicable” - it will be up to the PRA to decide what this means, but it would seem to create some leeway for groups to come up with pragmatic solutions based on their group structures – it is unlikely to be a ‘one-size-fits-all’ regime.

Operations

Operational infrastructure will need to be re-organised in order to meet the requirements. This will affect the structure of human resources, IT and systems, supplier arrangements, intellectual property, joint ventures, and other corporate resources. The operational workings of large complex banking groups are in themselves complex networks of people, contracts, and physical assets, and so this will be a complicated task. The challenge is how to retain the economies of scale which shared infrastructure creates, while complying with the independence requirements for the ring-fenced bank. There are two main options from which to choose: (1) the ring-fenced bank can provide operational infrastructure to the non-ring-fenced bank (this will likely fit with the design of a broad ring-fence structure), or (2) the group can utilise a dedicated, insolvency-remote operational subsidiary (OpSub) (or subsidiaries), discussed in Box 1.

Governance

As well as the ‘how’, there is the ‘who’ – ring-fenced banks will need independent governance arrangements: ring-fenced banks will need a certain proportion of board members who are independent of the ring-fenced entity, members who are independent of the rest of the group, and non-executives.

Box 1. Operational subsidiarisation

Operational subsidiarisation involves a distinct, insolvency-remote operational subsidiary (OpSub) which provides services to the rest of the group. The objective is to provide continuity of services. Resilience is achieved by migrating all operational infrastructure to this entity, so that it can act as a consolidated in-house service company to the entire organisation, providing everything from hardware to staff and intellectual property, to the market-facing businesses.

But an OpSub will not be suitable for every banking group. It creates design and implementation challenges of its own. Crucial decisions need to be taken around its location within the group, as well as ongoing funding and liquidity arrangements. The operational risks of migrating to an OpSub need to be considered carefully.

The UK Government has previously suggested that the appropriate proportion of independent members will be at least half, with no more than one third of the members of the ring-fenced bank’s board being representatives of the rest of the group. It remains to be seen where the PRA will come out on this issue. For groups where the ring-fence represents the overwhelming majority of the group’s business, there may be some flexibility in these requirements. However, this is not yet set down formally, and the term ‘overwhelming majority’ has not yet been defined.

Many banks currently organise themselves into business lines that don’t necessarily align to legal entity structures, with group boards and executive committees made up of representatives of the business lines and territories in which they operate. The structural reform agenda pushes banks towards a more formally aligned legal entity structure, and they will have to determine if and how this affects board and committee memberships, given that ring-fenced banks are also likely to need their own board committees in various areas, including risk, and remuneration.

The legal entity aspects of structural reform have consequences for board composition and committee memberships.

Particularly challenging will be to get the right dynamic between the group-level board and that of the ring-fenced bank – the board of the ring-fenced bank must be independent of the group, but will also owe a duty of care to the group board as its majority shareholder, which may generate conflicts.

Treasury, risk management and payments

The ring-fenced bank must have its own risk management arrangements. Clearly, it cannot rely on a treasury function situated within the non-ring-fenced bank. This means that it either needs its own independent treasury function, separate from that provided to the rest of the group, or a group treasury function needs to be in place with clearly demarcated areas of responsibility, and ring-fence-specific functionality. Importantly, the ban on trading activities within the ring-fenced bank does not prevent various risk management practices, such as hedging and the management of liquidity buffers.

Ring-fenced banks will also need to be direct members of payment systems, with a cap on the volume of payment services they can provide to the rest of their group. This may well mean that ring-fenced and non-ring-fenced entities need separate memberships of such systems.

5. Customers – where do they fit in?

Thought then needs to be given to how the bank will accommodate customers, both during the transition and in the end-state. Banks will want to prevent unnecessary difficulties being created for any customers who end up being ‘dual banked’ (an issue specific to the UK rules, without an EU counterpart at this stage). This may be particularly acute for smaller corporates, who must hold their deposits with a retail entity, but some of which have complex risk management needs, necessitating interaction with non-ring-fenced banks. How banks service the needs of such clients will be a big part of future customer relationship management.

The appropriate product mix in the ring-fenced bank relative to the rest of the group will be influenced by the make-up of each bank’s client base and the intended division of customers between the two. A predominantly retail-oriented group is likely to prefer to provide the majority of its ‘permitted’ activities from the ring-fenced bank. However, a bank whose clients are predominantly large corporates may choose the opposite.

The ring-fenced bank can distribute products manufactured elsewhere in the group. However, the relationship between the ring-fence and the rest of the group must be at arm’s length – that is, on commercial terms – and so such distribution agreements will have to be on the same terms as they would be with any external third party, affecting pricing, and influencing location of various ‘permitted’ activities.

6. Complicating factors – transfers and legacy issues

Within the set of options still on the table, it is then time to start thinking about the practicalities. What will need to be transferred where, and how will this be done? What are the potential stumbling blocks? Moving entities, assets and liabilities on the scale necessitated by ring-fencing will be a complex legal, regulatory and operational matter. Within any particular legal entity configuration, there will need to be transfers of assets and liabilities, including retail deposits, corporate deposits, mortgages, loans, derivatives, and other securities. There are various legal processes that can be used to effect transfers of these types of assets and liabilities.

The scale of the deposit transfers will depend upon decisions taken at earlier stages in the process, and for UK banks it will depend on the number of high net worth individuals and large corporates who have been through the ‘opt out’ process, potentially needing to have their deposits transferred outside the ring-fence. This will need to be done through ‘ring-fencing transfer schemes’ – a special form of Part VII transfer. These transfer schemes will require the consent of the PRA, subject to a report on the terms of the transfer scheme produced by an expert third party. Historically such transfers have been 12 – 18 month processes, but they have never been done on this scale before. This makes it imperative that transfer schemes are planned for early in the implementation timeline – in particular, they will need to be executed prior to any operational changes to accounts and financial instruments.

Unusual or unexpected legacy issues may also lie within the contracts underpinning banks' existing structures, including restrictions imposed by debt covenants, dividend blocks, taxation and pensions issues. These can be the result of past decisions which were (understandably) not taken with a view to unpicking them as part of a radical structural reform agenda. Many banks will be able to leverage work done in the context of resolution planning to work through these issues.

Legal entity restructuring can also have an impact on intangible assets such as deferred tax assets and goodwill. Groups will need to be careful not to impair such intangibles when transferring business or potentially re-branding.

Other knotty problems

Regulatory uncertainty

The fact that the Commission has only recently published its proposals for a Regulation in this area creates uncertainty, particularly given that they do not, and indeed cannot, marry up with all the existing national proposals in Europe. Unfortunately, this uncertainty looks set to continue into what is otherwise the implementation phase.

UK secondary legislation and PRA rules are also yet to be finalised, and it is the details of these which are most important in terms of how banks address ring-fencing. But this also makes high level planning all the more important in the short to medium term – once these details are published, it will be far easier to choose from among various options that have already been analysed rather than starting from scratch.

Integration with other regulatory reforms

There are clearly synergies with recovery and resolution planning, but there are also potential difficulties – complete independence of the ring-fenced bank's funding (i.e. debt issuance straight out of the ring-fenced operating entity) may not align with a preferred resolution strategy which foresees all debt issued out of a parent holding company.

Integration with the capital regime will also be an issue, with optimisation of capital across the group made more difficult by the segmentation of business lines and application of the rules on a sub-consolidated basis.

Banks with a significant US presence will also have to contend with the Volcker rule (which is likely to take effect earlier than the EU finishes its corresponding legislation, let alone embarks on an equivalence assessment of the US) and the enhanced prudential standards for foreign banking organisations, which will in some cases require the creation of an intermediate holding company to cover US subsidiaries, with further segmentation of global capital and liquidity.

Timing is all







The key to a smooth transition to ring-fencing will be to move early, but move thoughtfully and deliberately. Many of the components will take significant amounts of time to plan, gain approval, and execute. The complexity involved in certain aspects also suggests that it is better to manage the process in stages, rather than in a 'big bang' switchover close to the deadline date, particularly in terms of minimising operational risks.







Lingering regulatory uncertainty certainly doesn't help matters. But a lack of clarity around the finer details should not prevent broad brush design analysis from being undertaken, and even from more detailed planning based on hypothetical scenarios. Early planning with a range of scenarios will also help firms in their engagement with the regulator – being well prepared will be crucial.







In the UK, the final implementation date of January 2019 seems a long way off, but given the scale of the potential transformation, many firms will need to plan to implement these changes over a five year horizon. In many other jurisdictions, the case for action now is, if anything, even more powerful, given the legislative deadlines.







The key to a smooth transition to ring-fencing will be to move early, but move thoughtfully and deliberately.







Appendix – detailed comparative table of structural reform proposals

	EU 	UK 	France 	Germany 	Belgium 	United States 
Legislative progress	Initial proposal for a Regulation – must now make its way through full EU legislative process.	Primary legislation complete, consultation on draft secondary legislation conducted; additional regulatory rulemaking to follow in 2014/2015.	Primary legislation complete; secondary legislation yet to be published.	Primary legislation complete; secondary legislation yet to be published.	Draft law introduced in February 2014 following recommendations of expert Commission and Royal decree; additional National Bank of Belgium regulation to be expected.	Provisions included in Dodd-Frank Act, passed 2010; final rules adopted for Volcker; Enhanced Prudential Standards and swaps push-out.
Scope	EU G-SIBs, and credit institutions or groups which contain a credit institution; exceeding €30 billion in total assets and total trading activity exceeding €70 billion or 10% of total assets. Includes branches of non-EU credit institutions.	UK banks with over £25 billion deposits from European Economic Area (EEA) SMEs and individuals.	Banks whose trading activities or exposures to certain investment vehicles exceed an as-yet-unspecified threshold (to be determined by Ministerial Order).	Banks with over €100 billion trading-related assets or total assets of €90 billion of which trading-related assets are over 20%; or at the discretion of the Germany regulator, BaFin.	All Belgian banks taking deposits covered by the Belgian deposit guarantee irrespective of their size or systemic importance.	All banks with operations in US subject to Volcker Rule, although compliance requirements are proportionate to size; IHC requirements for banks with >\$50bn in US subsidiaries.
Prohibited activities	Institutions exceeding thresholds prohibited from proprietary trading and investing in alternative investment funds.	n/a	n/a	n/a	Proprietary trading, whether via Belgian or foreign subsidiaries; including certain relationships with hedge funds.	Volcker Rule prohibits proprietary trading and maintaining ownership interests in private equity and hedge funds.
Exemptions from prohibited activities	Trading in EU government bonds; cash management activities; investments in specific types of funds.	n/a	n/a	n/a	Investment services for clients, market making, hedging of own risks; liquidity management activities; buying and selling instruments with the objective to hold these instruments – ratio of associated market risk capital requirement to total regulatory capital may not exceed 1%.	Trading in certain government bonds; underwriting; market making; hedging; liquidity management; and activities solely outside the US.
Type of ring-fence	Trading ring-fence.	Retail ring-fence.	Trading ring-fence.	Trading ring-fence.	n/a	Although not characterised as a ring-fence the swaps pushout rule effectively requires separation of some derivatives activities from deposit taking.

	EU 	UK 	France 	Germany 	Belgium 	United States 
What must be inside the ring-fence?	<p>Any class of trading activities, at the discretion of the supervisor.</p> <p>Market making, complex securitisation and complex derivatives may be given particular attention.</p>	<p>Deposits of individuals and SMEs.</p> <p>Ring-fenced entities are prohibited from trading as principal in financial instruments and commodities.</p>	<p>Proprietary trading and certain unsecured transactions with leveraged funds.</p> <p>Market making could be ring-fenced if it exceeds a threshold to be set by Ministerial Order.</p>	<p>Non-customer related trading for own account, high frequency trading that does not constitute market making, lending and guarantees to hedge funds, funds of hedge funds or their management companies, or with highly leveraged alternative investment funds or their management companies.</p> <p>Market making and other transactions can be ring-fenced or banned at the discretion of BaFin (regardless of above mentioned thresholds being exceeded).</p>	n/a	n/a
Prohibitions on ring-fenced entities	Ring-fenced trading entity may not accept retail deposits or provide payment services.	Ring-fenced retail entity may not trade in investments as principal or commodities, or have exposures to financial institutions, or have non-EEA subsidiaries which conduct regulated activities.	Ring-fenced trading entity may not carry out derivatives transactions on agricultural commodities, or conduct high frequency trading if these are taxable in France, accept retail deposits, or provide retail payment services.	Ring-fenced trading entity not permitted to provide retail payment services or conduct e-money business.	n/a	Swaps pushout rule prohibits swaps dealers from accessing the Federal Reserve's discount window or FDIC deposit insurance.
Exemptions for ring-fenced entities	None	<p>'Simple' derivatives, securitisations of own assets, debt-equity swaps, and activities ancillary to own-risk management, management of liquidity buffers.</p> <p>Ring-fenced retail banks may have exposures to financial institutions for correspondent banking services, payments, trade finance, and liquidity management purposes.</p>	None	None	n/a	Certain derivatives are considered 'bank eligible' including those for the purpose of hedging and risk mitigation.

	EU 	UK 	France 	Germany 	Belgium 	United States 
Prohibitions on non-ring-fenced entities	Deposit-taking entity may not engage in ring-fenced trading activities.	Non-ring-fenced trading entity may not accept deposits of individuals or SMEs.	Non-ring-fenced retail entity may not engage in ring-fenced trading activity or have certain relationships with leveraged funds	Non-ring-fenced retail entity may not engage in ring-fenced trading activity or have certain relationships with hedge funds and highly leveraged alternative investment funds.	Credit institutions may not engage in proprietary trading including certain relationships with hedge funds, or exempted trading over 1% threshold.	Any organisation wanting to retain access to deposit insurance or the discount window will not be able to engage in equity, commodity and some credit derivatives.
Exemptions for non-ring-fenced entities	Deposit-taking entity may trade in certain derivatives for own-risk management and for sale to customers.	None	Non-ring-fenced deposit-taker permitted to provide investment services to clients, and MiFID 'ancillary' services; clearing services; hedging specified types of own risks; market making up to a threshold; treasury management.	Market making; trading activities on own account that constitute a service for others; hedging of transactions between clients and the bank; interest rate, currency, liquidity and credit risk management; purchase or sale of long-term participations; clearing and payment transactions; hedging of risks for customers; principal brokerage services; underwriting/ placement activities; portfolio management, investment brokerage, acting as central counterparty.	n/a	n/a
Other forms of exemptions	n/a	Non-EEA subsidiaries may be excluded from higher loss-absorbency requirements if they pose no risk to the UK.	n/a	n/a	n/a	n/a
Optionality	Any activities not explicitly prohibited from each type of entity permitted in either.	Any activities not explicitly prohibited from each type of entity permitted in either.	Any activities not explicitly prohibited from each type of entity permitted in either.	Any activities not explicitly prohibited from each type of entity permitted in either.	n/a	Bank eligible swaps may be provided from a bank or non-bank entity.
Governance	A majority of the board members of one subgroup cannot serve on the board of the other.	Majority of directors of ring-fenced bank must be independent of the ring-fenced bank and of the rest of the group.	n/a	Trading entity must have its own and separate management and supervisory board.	n/a	Non-US Banks with over \$50bn total US assets (branch and non-branch) must have a US-based Risk Committee and Chief Risk Officer.

	EU 	UK 	France 	Germany 	Belgium 	United States 
Additional structural restrictions	Groups subject to ring-fencing must be structured with “functionally homogenous subgroups” – deposit-takers on one side and trading entities on the other. Deposit-taking entities cannot hold shares or voting rights in trading entities.	Regulator may require a ‘sibling’ structure with ring-fenced and non-ring-fenced banks side-by-side under a holding company. Ring-fenced banks may not own non-ring-fenced banks.	n/a	Deposit-taker and trading entity may remain part of the same banking group (holding structure), but trading entity must be an economically and organisationally separate legal entity.	Trading entity may not be part of the consolidation perimeter of the credit institution, and Belgian trading entities must have a license as stockbroking firms.	Non-US banks with over \$50bn in US subsidiaries must structure their US subsidiaries under a US Intermediate Holding Company, which must meet US stress-test and risk based capital rules.
Intra-group relationships	Interactions to be at arm’s length. Deposit-taking entity may not have exposures of over 25% of its capital to any group entity outside its own subgroup.	Interactions to be at arm’s length. Ring-fenced bank exposures to other group entities subject to large exposure limit of 25% of capital.	Large exposure limits apply to intra-group exposures.	Interactions to be at arm’s length; large exposure limits apply to intra-group transactions.	Large exposure limits apply to intra-group exposures.	n/a
Additional operational requirements	Each subgroup required to issue its own debt, unless this conflicts with the group resolution plan; deposit-taking entity may not have exposures over 25% of capital to individual financial institutions or over 200% to financial institutions in aggregate.	Each side of the ring-fence to meet capital and liquidity requirements on a stand-alone basis. Ring-fenced bank must not depend on services provided by non-ring-fenced banks.	Standalone capital and liquidity requirements.	Trading entity required to ensure its own refinancing; shared infrastructure must be housed in the parent or other group entities.	n/a	IHC must have capabilities to meet US regulatory requirements (e.g. data, stress testing) on a standalone basis.
Capital requirements	n/a	Higher loss-absorbency – both capital and bail-in-able debt – for both types of entity.	n/a	Trading entity must comply with capital requirements set out under the German Banking Act.	Capital add-on in case trading book exceeds 15% of total assets or capital requirements of trading activities exceeds 10% of global capital requirements.	IHCs will be subject to US risk-based capital, liquidity and leverage rules.

	EU 	UK 	France 	Germany 	Belgium 	United States 
Compliance	Requirement to maintain a compliance programme and register all transactions and record systems and processes relevant to the Regulation.	tbc	tbc	Trading entity must set up a compliance function.	Trading activities must be tracked and monitored against size thresholds.	Compliance requirements for purposes of Volcker Rule and enhanced prudential standards are proportional to size, banks with over \$10bn assets require dedicated compliance programmes.
Timing	Estimated adoption June 2015; proprietary trading ban from January 2017; separation from July 2018.	Ring-fencing from January 2019.	Activities to be ring-fenced identified by July 2014; transfer of activities by July 2015.	Activities to be ring-fenced identified by January 2016; transfer of activities by July 2016.	Proprietary trading ban from 1 January 2015. Capital add-on applicable since 31/12/2013.	Volcker Rule compliance starts July 2015, reporting for large banks starts July 2014; swaps pushout rule came into effect January 2014, banks may apply for extension for 24 months; IHC requirements start January 2016, implementation plans due 2015.

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