The United Kingdom’s Ring-fencing Regime
A paper by Grant Liddell, senior legal counsel and manager, Legal Directorate, Bank of England, for the international conference on banking law on ‘The universal bank: a downfall?’, University of Naples ‘Federico II’, Department of Banking Law, 4 March 2016, Naples, Italy.

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Introduction and overview
This paper describes the major legal elements of the UK’s ring-fencing regime that had its genesis in the financial crisis and the report that the then government commissioned from the Independent Commission on Banking (ICB), chaired by Sir John Vickers (final report, 2011). The government accepted most of the Vickers’ proposals for a limited form of ring-fencing, with the intention that banks to which the regime applied would be structured and operated so as to ensure the continuity of provision of deposit taking services.

Vickers’s proposals for the ring-fence had the following key features:

- All deposits from individuals and small-to-medium enterprises, and any overdrafts they accessed would be deposits of the RFB (RFB);
- The RFBs would not be allowed to engage in trading or other investment banking activities, provide financial services to financial companies, or services to customers outside the EEA;
- The RFBs would be allowed to take deposits from larger companies and provide non-financial larger companies with other intermediation services such as simple loans;
- RFBs that formed part of a wider corporate group would need to have independent governance, be legally separate and operationally separable, and have economic links to other group members no more than substantial than those with third parties outside the group.
- They would be allowed to pay dividends as long as they maintained adequate levels of capital.

The mechanisms through which these features would be delivered were in terms of which services would be provided only by RFBs (described as ‘mandated services’), and which services RFBs would not be permitted to provide (‘prohibited services’).

The ‘mandated services’ would be those where even a temporary interruption to the provision of service resulting from the failure of a bank had significant economic costs, and customers are not well equipped to plan for such an interruption. Such services were envisaged to be the taking of deposits from, and the provision of overdrafts to, individuals and small and medium sized organisations. As well, RFBs would be entitled to engage in what Vickers called ‘ancillary services’, in substance, treasury functions. The ICB thought it was reasonable for RFBs to be able to, eg, hedge interest rate risk through the derivatives market even if they would not be permitted to provide such services to customers. In essence, it considered that RFBs ought to be able to engage in activities ancillary to the efficient provision of mandated services (although not as stand-alone business lines). They would be able to conduct treasury functions for risk management, liquidity management or to
raise funding for provision of services, and in doing so could transact with and become exposed to non-RFBs and non-bank financial organisations.

‘Prohibited services’ would be any that met the following criteria:

- Make it significantly harder or more costly to resolve the RFB;
- Directly increase the exposure of the RFB to global financial markets;
- Involve the RFB taking risk and which were not integral to the provision of payments services to customers, or the direct intermediation of funds between savers and borrowers within the non-financial sector;
- In any other way threatened the objectives of the ring-fence.

In particular, such services would be:

- Any service not provided to customers within the EEA;
- Any service which results in an exposure to a non-RFB or a non-bank financial organisation, except those associated with the provision of payments services;
- Any service which would result in a trading book asset;
- Any service which would result in a requirement to hold regulatory capital against market risk;
- The purchase or origination of derivatives or other contracts which would result in a requirement to hold regulatory capital against counterparty credit risk; and
- Services relating to secondary markets activity including the purchase of loans or securities.

The government broadly supported the Commission’s recommendations, and developed legislative proposals to implement them, in what became the Financial Services (Banking Reform) Act 2013. The Bill was, unusually, considered by a joint committee of both Houses of Parliament, which was especially established to consider issues relating to banks and their standards of operation in the wake of several scandals, notably allegations of fraudulent manipulation of LIBOR. This committee, the Parliamentary Commission on Banking Standards, was, after it had been set up to consider questions of banking standards, handed the additional remit of considering the Bill to legislate for the Commission’s proposals.

The government’s proposals involved much of the detail of the regime being provided in delegated legislation, in the form of statutory instruments to be made by the Treasury and by rules to be made by the regulator, the Prudential Regulation Authority (PRA).

The rationale for providing for the detail of the ring-fencing regime in this way was in order to confer responsibility on the regulator for the detailed implementation of the regime, while the government settled the main elements of the policy in the Act and the statutory instruments.

Financial Services (Banking Reform) Act 2013

Framework of regime
The Act amended the Financial Services and Markets Act 2000, the principal legislation in the UK for the regulation of banks and other financial institutions. It contains a mixture of unique UK elements in financial services legislation and other provisions required to implement (or enabling the implementation of) applicable European law, notably successive Capital Requirements Directives.
The Banking Reform Act introduced a new Part 9B ‘Ring-fencing’ and made amendments to key sections, such as to make special provision in the PRA’s statutory objective for ring-fencing and to provide for ‘ring-fencing transfer schemes’ (each of these is discussed further below).

The central premise of the legislation is that the thing to be protected is the continuous provision of ‘core services’ (the equivalent of the Commission’s concept of ‘mandated services’). The regulator’s objective is modified to address this need.

Part 9B is relatively limited, however, in how it provides further for the protection of the continuous provision of core services. It provides for the key concepts of ‘ring-fenced body’, ‘core activities’ ‘core services’, ‘excluded activities’, and ‘prohibited activities’, but not in a wholly comprehensive way, leaving detail and additional provision to be made by the Treasury by statutory instrument. It requires the PRA to make rules that require ring-fenced bodies to ‘make arrangements to ensure the effective provision to the ring-fenced body of services and facilities that it requires in relation to the carrying on of a core activity’ and rules relating to the interactions between ring-fenced bodies and other members of their groups.

Part 9B contains two other features. First, it recognises the complexity associated with untangling pension arrangements between a RFB and other members of its group, and so gives the Treasury power to make regulations that in substance allow a delay before ring-fencing affects pension liabilities.

Secondly, it provides a reserve power to the regulator, exercisable with the permission of the Treasury, in cases where a ring-fenced body is acting in egregious breach of the regime. The ‘group restructuring power’ or ‘electrification of the ring-fence’ as it quickly became colloquially known will enable the regulator to force divestment of members of a ring-fenced body’s group, but only after a lengthy process of notice, fair hearing, and the possible exercise of an appeal against the regulator’s decision.

The Act also amended the provisions of FSMA concerning banking business transfers. These enable a firm to seek an order of the court to enable the transfer of banking business to another entity, thus avoiding the need to novate individual contracts. In order to facilitate the reorganisation of banking groups that will be needed to prepare for the implementation of the regime on 1 January 2019, in particular so that ring-fenced bodies are structured so as not to be carrying out prohibited or excluded activities, a liberalised transfer system is provided for. Firms will be able to seek orders for ‘ring-fencing transfer schemes’ to transfer a range of business activities, not just banking business.

However, in order to be able to make an application to the court, firms will need the PRA’s consent, and the application must be accompanied by a report by a specially appointed ‘skilled person’ who is tasked with assessing whether the adverse effects likely to arise from the applicant’s proposed scheme are greater than is reasonably necessary to achieve the scheme’s intended ring-fencing purpose. Those purposes are purposes associated with enabling a firm to carry on core activities, and making provision to enable, in effect, the operation of a group with a viable non-ring-fenced body.
Key concepts: ‘ring-fenced body’
A ‘ring-fenced body’ is a UK-incorporated bank (ie it has a permission from the PRA under Part 4A of FSMA). Building societies (which also have such permissions) are excluded from qualifying as ring-fenced bodies. But only those banks that have over £25 billion in ‘core deposits’ will be ring-fenced bodies. The Treasury has set this monetary threshold by statutory instrument¹, having made the judgement that the Act requires that setting the threshold at this level would not be likely to have a ‘significant effect on the continuity of the provision of ... core services’. The effect of setting the threshold at this level is expected to result in the 6 largest banking groups in the UK that have between them about 70% of retail deposits coming under the regime at its commencement in 2019: HSBC, Lloyds, Barclays, Santander UK, RBS and Co-op. While the ICB recommended that only RFBs could carry on ‘mandated services’, the legislation does not prevent other banks that have deposit taking permissions from continuing to take deposits. It simply leaves them outside the regime, and means their customers will not have the protection that the regime will provide.

Key concepts: ‘Core activities’ and ‘core services’
The Act provides for the regulated activity of accepting deposits² to be a ‘core activity’, and enables the Treasury to add further activities by statutory instrument. The grounds on which such additional activities may be specified are that an interruption in the provision of services in the UK in carrying on the additional activity could adversely affect the stability of the UK financial system or a part of it, and that the continuity of the provision of those services can more effectively be protected by treating the activity as a core activity. No further activities have been specified to be a core activity.

‘Core services’ are, in relation to accepting deposits, the facilities for accepting them or other payments into depositors’ accounts, facilities for withdrawals or making payments from such accounts, and associated overdraft facilities. The Treasury is again given a power to add further services as core services, both to the existing core activity of accepting deposits and if further activities are specified as core activities.

Key concepts: Excluded activities – things RFBs can’t do
The Act provides that the regulated activity of dealing in investments as principal is an excluded activity, although the Treasury has the power to modify this exclusion, and has done so in the FSMA 2000 (Excluded Activities and Prohibitions) Order 2014 (‘EAPO’). Accordingly, not all activities that would fall within the category of the regulated activity of dealing in investments as principal are excluded. As well, the Treasury can specify further activities, whether regulated activities or not, to be excluded activities, if of the opinion that, having regard to the risks to which a ring-fenced body would be exposed if it carried on the activity, it considered that the carrying on of that activity would make it more likely that the failure of the ring-fenced body would have an adverse effect on the continuity of the provision of core services in the UK, and that such an order is necessary or expedient for the purpose of protecting the continuity of the provision of core services. The detail of what activities ring-fenced bodies may and may not engage in are discussed further below in the section relating to the EAPO.

¹ FSMA 2000 (Ring-fenced Bodies and Core Activities) Order 2014.
² References to ‘regulated activities’ are to FSMA 2000 (Regulated Activities) Order 2001, which specifies ‘regulated activities’ for the purposes of FSMA, s 22.
**Key concepts: Prohibited activities – who they can’t deal with**

The Act enables the Treasury by statutory instrument to prohibit ring-fenced bodies from entering into transactions of a specified kind or with particular classes of counterparties, and to restrict them from operating a branch in a particular place. The grounds for the making of such an order mimic those for making an order providing for additional excluded activities, and like that power, any such order may also provide for exemptions from the prohibitions, and conditions on the exemptions.

The legal mechanism deployed to make carrying on excluded or prohibited activities unlawful is to provide that contravention of an order imposing prohibitions or specifying excluded activities constitutes a breach of a ‘requirement’ imposed on the firm by the regulator. This refers, in effect, to requirements imposed by PRA rules and also requirements imposed on an individual firm through the exercise of the ‘requirements’ power in FSMA, section 55M. The consequence of breach of such requirements is to expose the firm to enforcement action by the regulator under FSMA, which includes the possibilities of fines or censures, and also potentially to the imposition of further firm-specific requirements that, for example, could seek to remediate the breach. By this provision, the PRA’s supervision remit is extended, so that for ring-fenced bodies, it is responsible not only for the range of matters that fall within its general objective of safety and soundness of banks, but also for policing ring-fenced bodies’ compliance with the substance of the ring-fencing regime.

**Amended PRA objective**

The PRA’s general objective of promoting the safety and soundness of authorised firms has been augmented in relation to ring-fencing matters so that, when discharging its ‘general functions’, it must do so in a way that seeks to:

- Ensure that the business of ring-fenced bodies is carried on in a way which avoids any adverse effect on the stability of the UK financial system; and
- Ensure that the business of ring-fenced bodies is protected from risks (whether arising in the UK or elsewhere) that could adversely affect the continuity of the provision in the UK of core services; and
- Minimise the risk that the failure of a ring-fenced body or of a member of its group could affect the continuity of the provision in the UK of core services.

The PRA’s objective is formally limited in its application to the PRA’s performance of ‘general functions’. They are specified to be its functions of making rules, of preparing and issuing codes where provided for by FSMA, and of determining its general policy and principles by which it will perform ‘particular’ functions. The reference to ‘particular’ functions is usually read to refer to its functions of taking regulatory action concerning an individual firm. Accordingly, the PRA must pursue its augmented general objective when it makes the ring-fencing rules that the Act requires. As well, when the PRA specifies its policies of how it will deal with particular matters in relation to ring-fencing, for example, as it has done in its policy statement concerning the legal structure and ownership of RFBs (PS10/15, May 2015), it must do so in a way that pursues this expanded objective. Practically speaking, the need to consider the safety and soundness of banks is almost always likely to be a relevant consideration when the PRA exercises any discretionary statutory power over a firm, which is why I describe the limitation of its application to general functions as ‘formal’. This will be the case also for the extended objective for ring-fencing.
Obligation on PRA to make ring-fencing rules

The Act requires the PRA to make rules for ring-fencing. Rules must address two matters:

- Requiring a ring-fenced body to make arrangements to ensure the effective provision to it of services and facilities needed in relation to the carrying on of the core activity of accepting deposits;
- Making provision for the ‘group ring-fencing purposes’ applying to ring-fenced bodies and members of a ring-fenced body’s group that are authorised under FSMA.

In general, the ‘group ring-fencing purposes’ address intra-group activities and transactions within groups containing ring-fenced bodies, in order to regulate intra-group transmission of risk. The group ring-fencing purposes are:

- Ensuring as far as reasonably practicable that the carrying on of core activities by a ring-fenced body is not adversely affected by the acts or omissions of other members of its group;
- Ensuring as far as reasonably practicable that in carrying on its business a ring-fenced body is able to take decisions independently of other members of its group; and
  - Does not depend on resources which are provided by a member of its group and which would cease to be available to the ring-fenced body in the event of the insolvency of the other member;
- Ensuring as far as reasonably practicable that the ring-fenced body would be able to continue to carry on core activities in the event of the insolvency of one or more other members of its group.

Parliament has gone on to specify that the following particular matters must be addressed by rules that are made for group ring-fencing purposes:

- requiring ring-fenced bodies to enter into contracts with other group members only on arm’s length terms;
- restricting distributions ring-fenced bodies may make to other group members;
- requiring disclosure to the regulator of information relating to transactions between a ring-fenced body and other members of its group;
- requiring the board of a ring-fenced body to include directors who are independent of other group members, directors who are independent of the ring-fenced body itself, and non-executive directors;
- requiring a ring-fenced body to act in accordance with a remuneration policy;
- requiring a ring-fenced body to act in accordance with a human resources policy; and
- requiring a ring-fenced body to make arrangements for the identification, monitoring and management of risk.

As well, there is an important catch-all provision that requires the regulator to make ring-fencing rules for any matter it considers necessary or expedient for any of the group ring-fencing purposes.

The PRA has so far consulted twice on draft rules. The first consultation in October 2014 concerned its proposals on legal structure, governance and the continuity of services and facilities. It published its final policy on those matters in May 2015. The second consultation was issued in October 2015.
on prudential requirements, intragroup arrangements and the use of financial market infrastructure. The PRA is still considering its final policy on these matters. It intends a third consultation on reporting and ancillary matters for 2016, after which final rules will be made.

**Special arrangements for pensions**
The Act provides the Treasury with a power to make regulations on matters relating to pension liabilities, and regulations were made in 2015 that provide that a split of pension liabilities between a RFB and other members of its group need not occur before 2026. The extra period of time recognises the difficulties and costs in splitting shared pension arrangements for defined benefit pensions.

**Activities in which RFBs may not engage: the provisions of the Excluded Activities and Prohibitions Order**
The Order specifies two excluded activities and three prohibitions, and exceptions to each.

**Excluded activities and exceptions**
RFBs may not engage in the excluded activities of (1) *dealing in investments as principal* and (2) *dealing in commodities*.

- Particular exceptions to the dealing in commodities excluded activity: an RFB may deal in commodities in order
  - To take or to realise a security interest over the commodities;
  - To enter into a title transfer collateral arrangement in relation to commodities, or to acquire and hold equivalent commodities in accordance with the arrangement or enforce the arrangement.

The following exceptions apply generally in the case of both excluded activities:
- Transactions by RFBs in order to limit the extent to which the RFB or its subsidiary or certain associated undertakings of the RFB will be adversely affected by:
  - Changes in interest rates, exchange rates of commodity prices;
  - Changes in any index of retail or property prices;
  - Changes in any share price index;
  - Default risk;
  - Liquidity risk.
- Transactions included for this purpose are buying or subscribing for investments to provide collateral for such a transaction, or selling such investments acquired for that purpose.
- Where the RFB buys, sells, or subscribes for investments which are liquid assets for the purpose of managing its liquidity, or to provide collateral.
- Where the RFB acquires or sells shares, debentures or instruments entitling it to such shares or debenture where those instruments are issued by the issuer and the RFB as consideration releases part or all of a debt the issuer or a member of the issuer’s group owes the RFB or the RFB’s subsidiary.

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3 FSMA 2000 (Banking Reform) Pensions Regulations 2015.
o Where the RFB deals in or sells debentures or instruments giving an entitlement to shares or debentures issued by the RFB or its subsidiary, or deals in debentures issued by a parent undertaking of the RFB.

o Where a RFB acquires a debenture where the debenture is acquired from the issuer and the debenture relates to any loan, credit, guarantee or other similar financial accommodation made by the RFB or its subsidiary to the issuer or a member of the issuer’s group.

o Where a RFB acquires or sells shares in a company which is or becomes a subsidiary of the RFB or in which the RFB has or will have a participating interest.

o Where a RFB takes, grants or realises a security interest over investments or enters into a title transfer collateral arrangement in relation to investments, acquiring equivalent investments in accordance with the arrangement or enforcing the arrangement.

o Where a RFB sells investments to or buys investments from its sponsored structured finance vehicle or conduit vehicle, or acquires an instrument creating or acknowledging indebtedness issued by one or more of its sponsored structured finance vehicles.

o Where a RFB enters into a transaction with a central bank or its wholly owned subsidiary in the course of dealing in investments as principal or it sells commodities to or buys commodities from a central bank or its wholly owned subsidiary.

o Where RFB enters into derivatives transactions on specified conditions:

  For all derivatives transactions:
  - The position risk requirement attributable to all transactions must at all times be less than 0.5% of the RFB’s own funds;
  - The sum of the position risk requirements attributable to each individual transaction with an account holder and calculated without any set offs between them is at all times less than 25% of the credit risk capital requirement of the RFB;
  - The sum of the position risk requirements attributable to options transactions by the RFB is at all times less than 20% of the sum of the position risk requirements entered into by the RFB for all forwards contracts, options and swaps;
  - There is evidence available at the date the transaction is entered into to assess the fair value of the investment in accordance with IFRS 13;
  - At the time the transaction is entered into, the investments traded as forward contracts, swaps or options fall within a class of derivatives that are traded on a trading venue in the EEA or a third country venue as defined in and that meets prescribed conditions under MiFID.

Position risk requirement means the capital requirements for position risk calculated in accordance with CRR, Part Three, Title IV, Chapter 2, and are to be calculated in accordance with those provisions, as if the positions associated with the investments are all held in the RFB’s trading book;
Credit risk capital requirement means the own funds requirements set out in CRR, art 92.3(a), excluding risk-weighted exposure amounts.

Where the transaction is a currency swap, an interest rate swap, or a forward contract concerning currencies or commodities, the following requirements apply as appropriate:

- Where the transaction is an option exercisable by a customer of the RFB requiring the RFB to buy or sell FX or commodities, the contract for the option must specify the currency or commodity, the amount, and a single date, no later than 3 years from the date of the contract, on which the option may be exercised.
- Where the transaction consists of a cap under which the RFB must pay the customer an amount equal to the difference between the interest payable at the interest rate prevailing during the specified calculation period (the floating interest rate) in relation to a specified notional amount and the interest payable on that amount at the interest rate specified in the agreement (the fixed interest rate), the agreement relating to the cap must specify the notional amounts, the fixed and floating interest rates and the calculation period.
- Where the transaction consists of a floor, the customer must pay the RFB an amount equal to the difference (so long as it is a positive number) between the interest payable in relation to a specified notional amount at the interest rate specified in the agreement (the fixed interest rate) and the interest payable in relation to that notional amount at the interest rate prevailing during the specified calculation period (the floating interest rate), the agreement relating to the cap must specify the notional amounts, the fixed and floating interest rates and the calculation period.
- Where the transaction consists of an option for the customer to enter into an interest rate swap, the agreement granting the option must specify a single date (no later than 5 years from the date of the contract) on which the option may be exercised, the terms which will apply to the interest rate swap, including the interest rates to which the swap applies, and the notional amount on which the swap payments are to be calculated.

Prohibitions

RFBs are prohibited from:

(1) entering into transactions that enable them to use services provided through an inter-bank payment system;
(2) incurring an exposure to a financial institution;
(3) establishing or maintaining a branch or subsidiary outside the EEA.

Inter-bank payment systems

Unless the RFB is a: (1) direct participant; or (2) if not a direct participant, it meets specified conditions as below, it may not enter into any transaction enabling it to use an inter-bank payment system’s services.

The conditions are:
The intermediary through which the RFB accesses the inter-bank payment system’s services is itself a direct participant of the system and is a member of the RFB’s group;

- The RFB is not eligible to become a direct participant under the rules of the inter-bank payment system;
- Were the intermediary to cease to be able to provide the RFB with access to the system’s services, the RFB could nonetheless make payments through another intermediary or through another inter-bank payment system or by other means;
- The regulator has granted the RFB permission to access the system through another intermediary because it considers the RFB needs to do so due to exceptional circumstances (as provided for in a public statement made by the regulator). The RFB retains the permission only for as long as the exceptional circumstances on which the permission was granted continue to apply.

An ‘inter-bank payment system’ does not include:

- A payment system operated by a recognised clearing house (which is a central counterparty or a clearing house providing clearing services but not as a central counterparty and which has a ‘recognition order’ issued by the Bank of England as regulator);
- A payment system operated by the operator of a relevant system approved by the Bank of England under regulation 5 of the Uncertificated Securities Regulations 2001;
- Arrangements the RFB makes with another credit institution for correspondent banking;
- Arrangements made to facilitate the physical transfer of money between financial institutions.

Financial system exposures

A RFB is prohibited from incurring a financial institution exposure unless an exception applies.

A financial institution exposure is an exposure by the RFB to a credit institution, an investment firm, a structured finance vehicle, a global systemically important insurer, a UCITS and alternative investment funds, a financial holding company and a mixed financial holding company.

It does not include a RFB, a building society, a body corporate incorporated outside the UK but in the EEA whose main purpose is to make loans secured on residential property and which are funded substantially by its members, a credit union, a recognised clearing house, an EEA central counterparty, and third country central counterparty, an investment firm that is not authorised to deal in investments as principal or as agent, or a UK or EEA credit institution which is subject to a requirement or condition imposed by its regulator not to engage in excluded or prohibited activities, and any of the international institutions named in the Schedule to the Order.

Exceptions

A RFB may incur a financial institution exposure if the sole or main purpose of the transaction (and including an exposure incurred in the course of buying, selling or subscribing for investments for the purposes of such a transaction) giving rise to the
exposure is to limit the extent to which the RFB, its subsidiary, its sponsored structured finance vehicle, its conduit vehicle or any of them together will be adversely affected by:

- Changes in interest rates, exchange rates, or commodity prices;
- Changes in any retail or property prices index;
- Changes in any share price index;
- Default risk.

A RFB may incur a financial institution exposure where the counterparty financial institution is a member of the RFB’s group, so long as the exposure itself is not prohibited by rules made by the regulator and the exposure arises as a result of a commercial transaction on arm’s length terms or of a holding of shares or other securities issued by a subsidiary of the RFB.

A RFB may incur a financial institution exposure where the exposure is a payment exposure and the RFB has complied with any rules or requirements imposed by the regulator in relation to payment exposures.

A payment exposure is (1) an exposure incurred in the ordinary course of settlement of FX transactions; (2) an exposure incurred in the ordinary course of the settlement of transactions for the purchase or sale of securities; (3) exposures arising from the provision of money transmission, including the execution of payment services, clearing and settlement in any currency, and correspondent banking; (4) exposures incurred by the RFB to meet conditions associated with its participation in an inter-bank payment system, a recognised clearing house, or an EEA central counterparty or third country counterparty, where such exposures are only to a financial institution which is itself a member or operator of any of those organisations.

Trade finance: a RFB may incur a financial institution exposure for the purposes of trade finance where:

- the purpose of the transaction is to provide finance or make a payment in connection with the supply of goods or services to a person which is not a financial institution or to guarantee or provide an indemnity or security in connection with the supply of goods or services by or to a person which is not a financial institution; but only if
- the contract specifies (1) the supplies of goods or services to which the transaction relates, and (2) the maximum payments the RFB may be required to make.

Securitisation and covered bonds: a RFB may incur a financial institution exposure to its sponsored structured finance vehicle.

Conduit lending: RFB may incur a financial institution exposure to a financial institution where:

- the only business of the financial institution in question is to acquire, hold and manage assets from or for an undertaking which is not a financial institution; and
- all or part of the financial institution’s assets are being used to form at least part of the security for any finance the RFB or the RFB’s conduit vehicle provides to it for the benefit of the undertaking that is not a financial institution;

A RFB may incur a financial institution exposure to a financial institution where:

- The financial institution in question was established for the benefit of another person; and
o The only business of the financial institution in question is to acquire, hold and manage assets for the other person, or to make loans or provide other finance at the direction or on the advice of the other person using the other person’s resources or resources raised in the financial markets to entities which are not financial institutions or to financial institutions whose only business is to acquire, hold and manage assets from or for an undertaking which is not a financial institution and whose assets are being used to form at least part of the security for any finance the RFB or the RFB’s conduit vehicle provides to it for the benefit of the undertaking that is not a financial institution.

**Repo transactions:** a RFB may incur a financial institution exposure to a financial institution pursuant to an agreement with that financial institution for the transfer of:

- the RFB’s assets to the financial institution on terms imposing an obligation on the RFB to buy from the financial institution or on the financial institution to transfer to the RFB those assets or assets of the same description at one or more subsequent times; or
- liquid assets from the financial institution to the RFB for the purpose of managing the RFB’s liquidity risk on terms imposing an obligation on the financial institution to buy from the RFB or on the RFB to transfer to the financial institution those assets or assets of the same description at one or more subsequent times.

**Ancillary exposures:** a RFB may incur a financial institution exposure to a financial institution in accordance with any rules made by the regulator where the exposure arises in consequence of:

- the RFB providing payment services to its customers anywhere;
- the RFB providing to the financial institution operational services or services as a trustee or agent in connection with a syndicated loan to an undertaking which is not a financial institution;
- the financial institution providing to the RFB services ancillary to or which facilitate:
  - the divestment or acquisition by the RFB of a subsidiary or other assets;
  - the continuing operation of a business, entity or assets which the RFB has acquired;
  - the issuing of securities by the RFB, its subsidiary or its sponsored structured finance vehicle;
  - the RFB’s participating in a syndicated loan to an undertaking which is not a financial institution;
- the RFB is acting as a distributor for a financial institution in connection with the distribution of trade finance or other financial products or investments issued by or services provided by the financial institution or in respect of which the financial institution is acting as distributor;
- the financial institution is acting as a distributor for the RFB in connection with the RFB’s providing trade finance or other financial products or investments issued by or services provided by the RFB to or for the benefit of an entity which is not a financial institution;
- guarantees, warranties, indemnities or covenants given to the RFB by a financial institution as part of an acquisition or disposal by the RFB or its subsidiary that is not prohibited by the Act, the Order or by rules made by the regulator;
o a breach of duty owed by the financial institution to the RFB;
o the appointment of the RFB as executor of an estate or the RFB’s providing services
in the capacity of an executor.
A RFB may incur an exposure to a financial institution which is a global systemically
important insurer where the exposure results from the purchase of insurance by the RFB for
the benefit of its business, directors, officers, employees or other staff or of those of its
subsidiary.

Transitional provision
RFBs are permitted to continue to hold or sell an investment acquired before the commencement of
the regime (1 January 2019) that would otherwise be in breach of the Order for a period of up to
two years after the commencement of the regime so long as the period remaining to maturity is less
than the two year period.

Non-EEA branches and subsidiaries
A RFB must not:
o Maintain or establish a branch in any country or territory outside the EEA;
o Have a participating interest in any undertaking incorporated in a country or
territory outside the EEA.
But a RFB may have a participating interest in a non-EEA undertaking if the undertaking is an
ancillary services undertaking as defined in article 4.18 of CRR, as long as the holding of the
interest is in accordance with rules made by the regulator and the undertaking does not
carry on any activities which if there were carried on in the UK would be regulated activities.

‘Electrification’

Power to require separation, ie divestment of property to a person outside the group
The PRA is given a power to break up RFB groups where certain conditions exist. T is known as the
‘group restructuring power’. The power is one that enables the PRA to require a RFB, another
authorised person in the group that is not an RFB, or a parent undertaking of an RFB to dispose of
property. In the case of the RFB, it may be required to dispose of specified property or rights to a
person outside the group, to apply to the Court for an order to transfer the whole or part of the
business of the RFB to an outside person, or to make arrangements discharging the RFB from
specified liabilities. In the cases of other persons on which requirements or directions may be
imposed, they may be required to divest themselves of interests in a RFB, to divest themselves of
any interest in any other member of the RFB group, to dispose of specified property or rights, or to
apply to the court for an order to transfer the whole or part of the their business. In each of these
cases, the requirement is to dispose of the interest etc to an outside person.

Grounds for exercise
The grounds on which the power may be exercised are that:

• the carrying on of core activities by the RFB is being adversely affected by the acts or
  omissions of other members of its group;
• in carrying on its business the RFB is either unable to take decisions independently or other
  members of its group or depends on resources which are provided by a member of its group
  and which would cease to be available in the event of the insolvency of that member;
in the event of the insolvency of one or more other members of its group, the RFB would be unable to carry on core activities;

the RFB or another member of its group has engaged or is engaged in conduct which is having, or would otherwise be likely to have, an adverse effect on the advance of the regulator’s general objective in relation to ring-fencing.

Process
Before the PRA may exercise the power, it must:

- first, give the person against whom it considers it will exercise the power a preliminary notice stating its intended action and reasons for proposing to act, and offering the person, and other affected persons such as the RFB if not the person concerned, an opportunity to make representations;
- second, decide whether in light of the representations to proceed further or not. If it decides to proceed, it must obtain the consent of the Treasury to the issue of a warning notice and allow a period for representations from the firm concerned of between 3 and 6 months. In deciding to proceed further, the PRA can choose to proceed with the originally notified action or it may specify a different action, if circumstances have changed since the preliminary notice was given.
- Third, decide whether, in light of representations, to issue a decision notice, which will constitute the formal exercise of the group restructuring power.

The person to whom the decision notice is issued may refer the matter to the Tribunal. There are safeguards built in to the procedure and the exercise of the power. The PRA may not use its ordinary requirements power under s 55M or its power of direction over a parent holding company under s 192C to effect an outcome that is available under the group restructuring power. It may not exercise the power against a person within two years of having previously exercised it against that person. The PRA must consult the FCA on a proposed issue of a warning notice or a decision notice. The PRA may after issuing a requirement through a decision notice vary the requirement at the request of or with the consent of the person concerned.

PRA draft rules
The PRA has so far conducted two of three consultations on draft rules and supervisory statements (statements containing guidance for firms on how they might comply with rules or otherwise stating PRA policy).

First consultation CP 19/14: The implementation of ring-fencing: consultation on legal structure, governance and the continuity of services and facilities
The first consultation paper concerning legal structure, governance and continuity of services and facilities was issued in October 2014, and the policy consulted on finalised in May 2015.

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Structure
The PRA’s policy is for a ‘sibling structure’ whereby a parent company directly owns a RFB and a ‘non-RFB’ (ie one undertaking activities which, if it were a RFB, would constitute excluded or prohibited activities). This avoids undue influence from the non-RFB over the RFB that could arise if the non-RFB owned the RFB.

Rules were not proposed, but the PRA signalled that it would consider using existing powers, as necessary and to the extent consistent with UK and EU law, to impose requirements on firms and/or to give directions to parent undertakings to implement the policy.

Governance
Several draft rules were proposed on governance matters, many of which were intended in implementation of the group ring-fencing purpose to ensure ‘as far as practicable that … a ring-fenced body is able to take decisions independently of other members of its group’.

Rules were proposed that:

- RFBs are able to take decisions independently of other members of the group;
- RFBs take all reasonable steps to identify and manage conflicts of interest with other group members; and
- RFBs take reasonable steps to identify and manage any conflicts between the duties senior management owe to the RFB and other interests they may have.

There was considerable comment on these draft rules, to the general effect that such an obligation would create tensions between an RFB and its parent, and upset group arrangements where a parent, by virtue of its ownership, could exercise control over subsidiaries.

The PRA stated that it sought to avoid ‘disrupting the usual mechanisms of accountability more than is necessary to achieve the statutory ring-fencing objectives’. It noted that requiring an RFB to be able to take decisions independently did not mean that its policies had to be at odds with those of the rest of the group, and noted that firms always had the opportunity to apply to have particular rules waived or modified.

Its policy on the use of rule waivers and modifications in the context of ring-fencing rules is notable for requiring firms that seek waivers to be able to demonstrate how their proposed arrangements will ensure that neither the advancement of the group ring-fencing purposes nor the PRA’s wider objectives are adversely affected. An applicant will be required to demonstrate to the PRA how its proposed governance arrangements will compensate for any potential weakening of the regime and how they will ensure the purposes of the regime are still being advanced.

A general rule was also proposed, without much commentary, that RFBs will be required to demonstrate how they are meeting the rules. The Policy Statement proposed to broaden the obligation so that firms would have to demonstrate not only compliance with ring-fencing rules, but with all other ring-fencing obligations, including those imposed by EAPO. The second consultation broadened the rule as just mentioned and added further features:

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6 PS 10/15, para 3.7.
7 PS 10/15, para 3.17.
A requirement to be able also to demonstrate the extent to which a RFB has acted in accordance with any guidance the PRA has issued relating to the operation of the ring-fencing obligations;

- Requiring one entity within an RFB sub-group take responsibility for demonstrating the compliance with ring-fencing obligations of all entities within the sub-group and the extent to which they have acted in accordance with guidance as just described;

- Requiring RFBs to have policies regarding their use of exceptions to the excluded activities and prohibitions imposed in EAPO.

**Continuity of services and facilities**

The PRA proposed rules and a supervisory statement to ensure that RFBs have appropriate arrangements concerning the services and facilities they need to provide core services. These proposals are intended to be harmonised with more widely applying rules currently being consulted on that are designed to provide for operational continuity in resolution and to facilitate recovery and post-resolution restructuring.

**Second consultation: CP37/15: The implementation of ring-fencing: prudential requirements, intragroup arrangements and the use of financial market infrastructures, issued October 2015**

**Intragroup prudential arrangements**

Prudential requirements are imposed on banks principally pursuant to European legislation: the Capital Requirements Regulation and the Capital Requirements Directive. They concern requirements relating to levels of capital, liquidity and to large exposures. They can be imposed at different levels, including at the individual level of the firm and at the level of the consolidated group. CRR permits member states to supplement these levels of prudential requirements with a ‘sub-consolidated’ approach, in respect of a sub-group of entities within a banking group where such sub-groups are created pursuant to national legislation providing for structural separation of banking activities within a group.\(^8\)

The PRA has provided for sub-groups to be established using the power in the CRR just referred to. The expectation is that a RFB may have a sub-group comprising entities that if they were RFBs would not be carrying out excluded or prohibited activities. The RFB and its sub-group members would be required, in accordance with CRR, to meet prudential requirements on a sub-consolidated basis separately from other entities in the group.

A sub-group offers a benefit that the RFB and the sub-group members have sufficient resources without relying on other group members, which also reduces the risk that loss-making entities elsewhere in the group threaten the resilience or resolvability of the RFB.

CRR permits intra-group concessions concerning risk weights, large exposure limits for exposures to other group members, and liquidity. The PRA will limit the availability of the concessions to the members of the sub-group, because to continue to permit them to be available in relation to members of the group that are not in the sub-group would create a dependency on such other

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\(^8\) CRR, article 11(5).
group members. Doing so would not be consistent with the aim of ensuring that a RFB is resilient and not adversely affected by the acts or omissions of other group members.

The PRA took the concept of the sub-group created under the framework of the CRR and has proposed that many of its own ring-fencing rules would be applied as well at the level of the sub-group, in particular those concerning intragroup transactions and exposures.

**Intragroup transactions and exposures**

To comply with obligations imposed on the PRA by the Act, the PRA has proposed rules that have the effect of insulating the RFB from other members of its group. Many of these draft rules will apply to members of an RFB’s sub-group.

Proposals include:

- Rules requiring an RFB to enter into contracts with other group members on arm’s length terms. These draft rules will apply to an RFB’s transactions with all other group members, including those with members of its sub-group. They will also apply to transactions of members of the sub-group with members of the group not in the sub-group. Firms will also have to establish policies and procedures to support their ability to ensure that transactions are conducted on arm’s length terms.

- Rules requiring that an RFB and entities within its sub-group apply the same standards to their management of exposures to, and arrangements with group members who are not in the sub-group as they would to third parties, so that the carrying on of core activities is not adversely affected by those group members.

- A rule requiring that an RFB and members of its sub-group not become, as far as is reasonably practicable, dependent on income generated from members of its group that are not in the sub-group to an extent that if such income were to reduce it would result in the RFB being unable to conduct core activities.

- A supervisory statement to the effect that where an RFB or an entity in its sub-group receives collateral from other group members outside the sub-group, the RFB must ensure that the collateral is of equivalent quality, in terms of liquidity and credit, and managed to the same extent as collateral received from persons outside the group.

- A rule requiring that an RFB and entities in its sub-group may not enter into netting arrangements which permit a counterparty to offset liabilities to the RFB or other entities in the sub-group with claims that the counterparty has on other group members outside the sub-group in the event of default of one of the parties.

- A rule that an RFB and entities in its subgroup must ensure that collateral would not cease to be available to them as a result of the acts, omissions or insolvency of entities outside the sub-group.

**Use of financial market infrastructures**

RFBs’ use of financial market infrastructures is a key operational activity for financial markets and their participants. They also pose a source of risk to RFBs.

The PRA is given a power under EAPO to permit RFBs to enter into transactions that require the use of services provided through an interbank payment system in cases where they are not a direct member of the system. EAPO otherwise restricts RFBs from accessing such systems except where
they are direct members or in some limited other circumstances. The PRA may permit such indirect access (via an intermediary proposed by the RFB) only where there are ‘exceptional circumstances’, and it must publish guidance on what it considers will constitute such ‘exceptional circumstances’.

The proposed guidance will state that ‘exceptional circumstances’ will exist where direct participation carries costs that are disproportionate to the degree to which direct participation would contribute to the achievement of the PRA’s safety and soundness objective in relation to ring-fencing, and where an RFB is not at the time a direct participant in the system and that joining a system at a particular time would be more significantly more costly than doing so at a later date.

RFBs need to access central security depositories to settle securities such as equities and bonds, and to access central counterparties to centrally clear over-the-counter and exchange-traded derivatives, in order to manage the RFB’s own risk or provide services to customers.

The PRA proposes a supervisory statement that will state that RFBs should participate in CSDs and CCPs in a manner appropriate to the activity and business model of the RFB, which will include direct participation in some cases.

It also proposes a rule that where the RFB accesses the CSD or CCP through an intermediary, the RFB uses accounts which ensure a sufficient degree of separation of the RFB’s assets from those of its intermediary and those of the intermediary’s other clients.

**Reporting and ancillary issues – foreshadowed in CP2 for CP3**

Additional reporting will be required from RFBs in order to enable the PRA to monitor compliance by RFBs with ring-fencing obligations and for the prudential supervision of RFB sub-groups. Detailed proposals will appear in CP3, by mid-2016. This third CP will deal also with any remaining matters requiring consultation.

**Preparing for commencement**

**Firms’ plans**
The PRA has asked firms in 2015 and again in 2016 for their plans for the implementation of the ring-fencing regime. While plans remain to a degree provisional pending the finalisation of the rules, firms are getting closer to final detail of their arrangements for how they will restructure their businesses, what new permissions they might need, whether they will seek waivers or modifications of particular rules, and so on. The PRA has a substantial programme of work to ensure that firms are in a state to comply with the regime from its commencement. Given the size of the firms and their significance in the economy, the complexity of the reorganisation will be unlike anything previously seen. Ring-fencing transfer schemes will be developed this year and formal applications likely in early 2017, with intended implementation of them in early 2018, to give a substantial lead in time before 1 January 2019.