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FINANCIAL MARKETS LAW COMMITTEE

ISSUE 175

BANKING REFORM (RING-FENCING)

*Financial
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FINANCIAL MARKETS LAW COMMITTEE

ISSUE 175 WORKING GROUP

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Dorothy Livingston	Herbert Smith Freehills
Bob Penn	Allen & Overy
Jan Putnis	Slaughter and May
John Roy	HSBC
Joanna Perkins	FMLC Director
Laura Evans	FMLC Legal Assistant

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1 INTRODUCTION AND EXECUTIVE SUMMARY

Introduction

- 1.1 The role of the FMLC is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the financial markets which might give rise to material risks and to consider how such issues should be addressed.
- 1.2 The implementation of the ring-fencing proposals for UK banks set out in the draft Financial Services (Banking Reform) Bill (the “draft Bill”) represents a substantial change to the structure of the UK banking sector. This paper addresses areas of legal uncertainty arising from the proposed ring-fencing provisions in the draft Bill. The FMLC considers that these legal uncertainties fall into three categories: (i) the compatibility of the draft Bill with EU law; (ii) uncertainties within the text of the draft Bill; and (iii) the location and height of the ring-fence.

Executive summary

- 1.3 The FMLC considers that the draft Bill sets out a high-level framework for ring-fencing, but does not provide sufficient legal certainty.
- 1.4 Certain provisions in the draft Bill are potentially incompatible with EU law. The draft Bill provides for a continuity objective which, as currently drafted, may indirectly discriminate against nationals of other Member States in contravention of Article 18 of the Treaty for the functioning of the European Union (the “TFEU”). Further, the provisions in the draft Bill which relate to depositor preference and group support are potentially incompatible with the proposed Rescue and Resolution Directive (the “RRD”). Although the FMLC considers that the potential incompatibility between the continuity objective and Article 18 of the TFEU can be resolved by amendments to the drafting, the potential incompatibilities with the RRD may require more substantial changes.
- 1.5 The FMLC is of the view that amendments to the drafting of the draft Bill are required to remove legal uncertainty arising from the definition of “core services” and that the provisions in the draft Bill which set out transitional

measures may require further review in order to provide certainty as to the enforceability of existing arrangements between banks and their customers.

- 1.6 Finally, the FMLC considers that certain provisions of the draft Bill concerning the height and location of the ring-fence should be clarified in order to provide greater certainty as to the legal, economic and operational independence of the ring-fenced bank and the scope of ring-fencing policy.

2 COMPATIBILITY WITH EU LAW

The continuity objective

- 2.1 Proposed new sections 1EA and 2BA Financial Services and Markets Act (“FSMA”) provide for a continuity objective in respect of ring-fencing, ring-fenced bodies, UK corporate entities which are members of a group which contains a ring-fenced body and applications which, if granted, would result in a person becoming a ring-fenced body. Proposed new section 1EA FSMA provides for the Financial Conduct Authority’s continuity objective; proposed new section 2BA FSMA provides for the Prudential Regulation Authority’s continuity objective.¹ The continuity objective is described as “protecting the continuity of the provision in the United Kingdom of core services”. The FMLC is of the view that the continuity objective, as currently framed, may not be compatible with EU law.

- 2.2 Article 18 of the TFEU prohibits discrimination on the grounds of nationality and is binding on the UK and other Member States. The FMLC’s concern is that the continuity objective, by focusing on the provision of core services in the UK, may indirectly discriminate against nationals of other Member States in breach of Article 18 of the TFEU.

- 2.3 There are two cases relevant to the interpretation of Article 18 of the TFEU in this context:

- a. *Criminal proceedings against Lopes da Silva Jorge* [2012] 3 C.M.L.R. 54

¹ For simplicity, and due to the similarity between proposed new section 1EA FSMA and proposed new section 2BA FSMA, the continuity objectives of the Financial Conduct Authority and the Prudential Regulation Authority are referred to in the singular in this paper.

This case was a reference from the French courts and was concerned with whether an exception from surrender to the European Arrest Warrant was contrary to the principle of non-discrimination on grounds of nationality. The exception in question provided that surrender could be refused if the subject of the warrant was (a) a French national and (b) the French authorities undertook to allow the person to carry out their sentence in France. The Framework Directive under which the exception was permitted, however, allowed the exception to be extended to residents as well as nationals.

The court held that Member States could not limit the application of the exception to nationals; to do so would be to undermine the principle of non-discrimination on the grounds of nationality. Rather, the provision should apply to nationals and citizens of other EU Member States who were in a “comparable situation” due to long residence and economic and other links.

This decision underlines the fact that laws which are capable of preferring nationals to non-nationals in a comparable situation may be impugned as in breach of the principle of non-discrimination. It is not clear whether depositors and clients of a non-UK branch of a bank subject to the continuity objective would necessarily be in a comparable situation to UK depositors and clients of the same bank, but the EU approach (including the terms of the EU Directive on deposit insurance schemes) suggests that depositors throughout the EU who deal with the same bank are likely to be regarded as comparable regardless of which branch holds their deposit. The case offers little guidance as to what will otherwise be regarded as being “comparable”.

b. *Missionswerk Werner Heukelbach eV v Belgium* [2011] 2 C.M.L.R. 35

One of the questions which arose in this case was whether a Belgian lower rate of inheritance tax available only to not-for-profit bodies with a place of establishment in Belgium was contrary to Article 18 of the TFEU. The court found on the facts that Article 18 of the TFEU did not apply where a more

specific non-discrimination regime applies.² In this case, the regime on free movement of capital provided a more specific set of rules on non-discrimination.

It is not clear that the free movement of capital rules will be engaged in the context of the continuity objective. If they are, similar considerations may arise. One example of where such a consideration might arise is in a situation in which non-UK branches in the EU are closed in a restructuring, while branches in the UK are maintained. This might be seen as a restriction on the ability of customers of the closed branches to move their capital within the EU. A similar concern would arise if UK deposits were transferred to a bridge bank while other EU deposits (above the guarantee limit at least) were retained in an insolvent bank.

- 2.4 The continuity objective invites the regulator, when exercising its power, not only to have regard to the provision of core services in the UK but to disregard the effects in any other Member State. The continuity objective might therefore reasonably be regarded as, for example, encouraging discrimination against customers of EU and/or EEA branches outside the UK of a UK regulated bank as compared to customers of UK branches of the same bank. It is a reasonable inference that customers of non-UK branches will be predominantly non-UK citizens and non-UK companies and that customers of UK branches will be predominantly UK citizens and UK registered companies.
- 2.5 The UK authorities in theory could fulfil the continuity objective by, for example, keeping open UK branches of a failing bank they regulated, while shutting down branches of the same bank in other EU States. Another possibility is that UK customers of the bank could be transferred to a bridge bank while leaving those whose accounts are in EU and/or EEA branches outside the UK with the insolvent bank. While the provision would not in practice disadvantage EU depositors who benefit from the UK depositor

² This point was also made in *Commission of the European Communities v Greece* (305/87) [1989] E.C.R. 1461; *Hollmann v Fazenda Publica* (C-443/06) [2007] E.C.R. I-8491; and *Commission of the European Communities v Germany* (C-269/07) [2009] E.C.R. I-7811; [2010] 1 C.M.L.R. 9.

protection scheme for their deposits (by law this is required to extend to customers of branches anywhere in the EU and EEA), it would disadvantage and/or discriminate against them in relation to unprotected deposits (over £85,000 or amounts held by depositors not eligible for the scheme) and in respect of the loss of banking services that the UK customers continue to enjoy.

- 2.6 Should the continuity objective be found to be incompatible with Article 18 of the TFEU, the UK could be exposed to damages claims from parties adversely affected by measures taken in achieving the continuity objective. Indeed, all creditors, not only EU ones, might have claims if they were prejudiced by any action taken in pursuance of the continuity objective.
- 2.7 The fact that the continuity objective is enshrined in primary legislation would not provide a protection (*Re Factortame*).³ If the risk of incompatibility is to be avoided, the terms of the continuity objective should be amended so that such discrimination could not arise.
- 2.8 The FMLC's preferred solution would be to amend the continuity objective to refer to the preservation of the capability to provide core services by banks whose resolution falls within the responsibility of the UK authorities (in practice this is UK regulated banks). This amendment would bring the EU and/or EEA operations of UK regulated banks into the scope of the continuity objective and would be consistent with the approach being taken by the Bank of England in discussions with non-EU regulators (see, for example, the joint paper with the Federal Deposit Insurance Corporation which provides that financial stability concerns should be addressed across all jurisdictions in which the firm operates, requiring close co-operation between home and foreign authorities).⁴ One approach to the drafting would be to delete the last reference to "in the United Kingdom" and add the words "subject to resolution under the Banking Act 2009" after the words "core services" in each of

3 [1990] 2 Lloyd's Rep 365.

4 "Resolving Globally Active, Systemically Important, Financial Institutions, a joint paper by the Federal Deposit Insurance Corporation and the Bank of England", published on 10 December 2012.

proposed new sections 1EA(3)(a), (b) and (c) and each of proposed new sections 2BA(3)(a), (b) and (c) of FSMA so that they read “the continuity of the provision of core services subject to resolution under the Banking Act 2009”. This would also pick up amendments to the scope of that Act having regard to the rules of statutory interpretation.

- 2.9 An alternative solution would be to amend the continuity objective to refer to the preservation of core services for sterling transactions. The FMLC, however, considers this solution to be less certain than the one provided at paragraph 2.8; some risk of incompatibility with Article 18 of the TFEU remains given that UK citizens use sterling more than citizens of other EU and/or EEA states.

Depositor preference

Depositor preference and claims on liquidation

- 2.10 The FMLC is of the view that the proposals in respect of depositor preference in the draft Bill are potentially inconsistent with the draft RRD.⁵ This inconsistency arises from the way in which deposit guarantee schemes are dealt with under the RRD.
- 2.11 The draft Bill proposes that deposits covered by the Financial Services Compensation Scheme (“FSCS”) be preferential debts under Schedule 6 of the Insolvency Act 1986. The draft Bill provides for a new Category 7 of preferential debt at paragraph 15B (*Deposits covered by the Financial Services Compensation Scheme*):

So much of any amount owed at the relevant date by the debtor in respect of an eligible deposit as does not exceed the compensation that would be payable in respect of the deposit under the Financial Services Compensation Scheme to the person or persons to whom the amount is owed.

⁵ References in this paper to the RRD are to the draft directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEA and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) 1093/2010, published on 6 June 2012.

An “eligible deposit” is defined as

a deposit in respect of which the person, or any of the persons, to whom it is owed would be eligible for compensation under the Financial Services Compensation Scheme.

A deposit is defined by reference to paragraph 22 of Schedule 2 FSMA or section 1(2)(b) of the Dormant Bank and Building Society Accounts Act 2008.

2.12 Article 11 of the Deposit Guarantee Schemes Directive (the “DGSD”)⁶ provides that:

Without prejudice to any other rights which they may have under national law, [deposit guarantee] schemes which make payments under guarantee shall have the right of subrogation to the rights of depositors in liquidation proceedings for an amount equal to their payments.

2.13 Article 99(2) of the RRD, however, requires Member States to ensure that deposit guarantee schemes rank *pari passu* with “unsecured non-preferred claims” under national law governing “normal insolvency proceedings”.

2.14 Article 11 of the DGSD suggests that if depositors who are entitled to FSCS protection are given preferred status in the UK to the extent of that entitlement (which the draft Bill proposes to do), then the FSCS should also have such preferred status in the liquidation of a UK bank. This, however, appears to be inconsistent with Article 99(2) of the RRD and calls into question the concept of insured depositor preference.

2.15 There is no clear explanation of Article 99(2) in the European Commission’s Explanatory Memorandum on the RRD which simply states that:

6 94/19/EC.

In order to provide for sufficient funding, the ranking of deposit guarantee schemes in the hierarchy of claims is introduced, with DGS ranking *pari passu* with unsecured non-preferred claims.⁷

Nor is any further guidance provided by the European Parliament ECON Committee in their draft report on the RRD published on 11 October 2012.

2.16 The FMLC is of the view that further consideration should be taken of the relationship between the draft Bill and the RRD in this regard.

Depositor preference and insolvency law

2.17 There is potentially a lack of clarity as to the relationship between the preference proposed by the draft Bill and UK insolvency law. UK insolvency law provides for the set-off of credit and debit balances; the FSCS provides protection to gross balances. If the gross amount of the deposit protected by the FSCS is to be given preference without set-off, it might allow for preference to be given to a sum in excess of the one which the depositor can currently claim in insolvency. This may also impact on the net reporting of liabilities to guaranteed depositors. The FMLC considers that further clarification of (a) the relationship between the proposed preference and the law on set-off and/or netting (both generally and in the context of insolvency) and (b) the effect of the proposed preference on prudential reporting and accounting requirements, may be helpful in this regard.

Depositor preference and drafting of the FSCS rules

2.18 A further concern arises from the depositor preference proposal in the draft Bill. By granting preferential status to depositors to the extent of their entitlement under the rules of the FSCS, the uncertainties in the drafting of those rules would arise where, in the context of the insolvency of a bank, the entitlement of depositors falls to be determined.

⁷ See page 16 of the Explanatory Memorandum accompanying the RRD.

2.19 Although the details of the uncertainties under the rules of the FSCS are beyond the scope of this paper, in summary they concern (i) the applicability of exclusions from entitlement to compensation under the rules of the FSCS and (ii) the position of certain beneficiaries of deposits held by other persons. The FMLC considers that there is a strong case for reviewing the rules of the FSCS and improving their clarity in the context of the depositor preference proposals.

Group support

2.20 The FMLC considers that there is a potential incompatibility between the draft Bill and the RRD in respect of group support.

2.21 The RRD makes provision for “group financial support agreements”⁸ under which, broadly, and subject to conditions, certain holding companies and certain of their subsidiaries⁹ may enter into agreements to provide financial support to any other party to the agreement that experiences financial difficulties. Member States are required to “ensure” that group entities may enter into such agreements.¹⁰

2.22 Legal uncertainty arises in that such an agreement could provide for support across the boundary of the ring-fence. Thus, a group financial support agreement would be provided in a way that is fundamentally inconsistent with the ring-fence itself. One example of where this might arise is where support is provided from a retail bank to an investment bank. Although the RRD permits competent authorities to prohibit or restrict the provision of support pursuant to a group financial support agreement,¹¹ the RRD does not allow competent authorities to oppose the existence of the agreements themselves.

2.23 The FMLC is of the view that further consideration should be taken of the relationship between the draft Bill and the RRD in this respect.

⁸ See Title II, Chapter III (articles 16-22 inclusive) of the RRD (Intra-Group Financial Support).

⁹ The subsidiaries that may be party to such agreements are “institutions” (meaning credit institutions or investment firms) and “financial institutions” (as currently defined in article 4(5) of Directive 2006/48/EC).

¹⁰ Article 16(1).

¹¹ Article 21 of the RRD.

3 UNCERTAINTIES IN THE TEXT OF THE BILL

The definition of a “core service”

- 3.1 The FMLC considers that the definition of “core services” at section 142C FSMA is unclear. As currently drafted, it is not clear whether a “core service” is a service provided to a customer (for example, saving, transferring money and borrowing); an aspect of the infrastructure provided by UK regulated banks (for example, branches, employees and IT systems); or, a service provided to banks by external infrastructure providers (for example, clearing houses). Given that the definition of “core services” feeds into the continuity objective, the FMLC is of the view that it would be helpful if the definition provided greater clarity.
- 3.2 The use of the term “facilities” in the definition of core services (at section 142C(2)(a) and (b)) is also ambiguous; it could refer to either infrastructure (for example, IT systems and distribution networks) or certain types of arrangement (for example, a loan facility or an overdraft facility) which allow borrowing or re-borrowing up to or within a defined limit.¹²
- 3.3 Given the distinction made in the draft Bill between core services and core activities, it appears that the term “facilities” is intended to refer to banking infrastructure. If so, thought should be given to whether “facilities” is properly included in the definition of core services. Language such as “the means by which customers are able” might better communicate the arrangements which the concept is intended to capture.
- 3.4 The Financial Services Authority, in its consultation paper on the Recovery and Resolution Plans published on 9 August 2011, provided a list of 25 economic functions for the purposes of identifying “critical economic functions” (paragraph 4.35 of the consultation paper). A critical economic function is described at paragraph 4.39 of the consultation paper as “a product/activity of the firm whose withdrawal or disorderly wind-down could have a material

¹² The definition of core services uses the term “facilities” in respect of (i) accepting deposits or other payments to an account; (ii) withdrawing money or making payments in respect of an account; and (iii) overdrafts. In the first two of these three references the term “facilities” would appear to most naturally refer to infrastructure. In the third reference, the term seems to refer to the type of “at will” borrowing commonly known as an overdraft facility.

impact on the UK economy or financial system.” The FMLC considers that it would be helpful for HM Treasury to provide a similar list of “core services”. If, contrary to the FMLC’s assumption, the term “core activities” is intended to refer to the products and/or activities provided, rather than the means by which they are provided, then items on this list of economic functions might provide a useful checklist. A definition of current account banking (discussed, for example, in the Competition Commission’s report on current account banking in Northern Ireland)¹³ might also provide useful wording.

Transitional issues

3.5 The draft Bill proposes amending section 106 FSMA to allow business to be transferred from the ring-fenced bank to the non-ring fenced bank by way of a banking business transfer under Part VII FSMA. A banking business transfer under Part VII FSMA allows for the transfer of a book of banking business by operation of law (specifically by application to the court) without requiring the consent of customers.

3.6 The draft Bill proposes a new sub-section 106(2A) FSMA which provides that:

a scheme is also a banking business transfer scheme if it –

(a) is one under which the whole or part of the business carried on by a UK authorised person who has permission which includes permission to carry on one or more core activities (“the authorised person concerned”) is to be transferred to another body (“the transferee”),

¹³ “Personal current account” is defined in the Competition Commission’s report on current account banking in Northern Ireland (published in May 2007) as “an account, marketed to individuals not businesses, which provides the facility to hold deposits, receive and make payments (cheques and debit cards) and use automated teller machine (ATM) facilities and to make regular payments (direct debit and standing orders).”

(b) is being made for the purpose of avoiding a ring-fencing contravention that would or might arise if the whole of the business of the authorised person concerned continued to be carried on by the same person, and

(c) is not an excluded scheme.

A “ring-fencing contravention” is defined in the draft Bill as:

(a) a contravention within section 142G (ring-fenced bodies not to carry on excluded activities or contravene prohibition), or

(b) a contravention of ring-fencing rules.

It appears that new sub-section 106(2A) envisages a banking business transfer scheme under Part VII FSMA being used both (i) at the outset when a bank is establishing a ring-fence and (ii) in the life of the ring-fenced bank, to transfer business which, if it were maintained in the ring-fenced bank, would cause a ring-fencing contravention. A banking business transfer scheme might be required in the life of the ring-fenced bank where, for example, the regulator makes new rules (using its powers under new section 142H) to ensure that the carrying on of core activities by a ring-fenced body is not adversely affected by acts or omissions of other persons, and that a ring-fenced body which is a member of a group can act independently of other members of that group in carrying out its business.

3.7 Banking business transfer schemes under new sub-section 106(2A) are discretionary, being subject to a permission from the court being granted. The draft Bill proposes that banking business transfer schemes under new sub-section 106(2A) be subject to the existing conditions for banking and insurance business transfers under Part VII of FSMA. In addition to the court being satisfied that certain procedural requirements have been satisfied, the court must, pursuant to section 111(3) FSMA,

consider that, in all the circumstances of the case, it is appropriate to sanction the scheme.

- 3.8 In assessing whether to grant permission for the transfer, the court will seek to give due recognition to the commercial objectives and judgments of the boards of the transferor and transferee (*Re London Life Association Ltd*¹⁴). The court will also consider certain principles established in *Re London Life Association Ltd* (a case which, although it concerned an application for an insurance business transfer rather than banking business transfer under the law which preceded Part VII FSMA, is still relevant):
- a. the effect of the transfer on policyholders' (or, in the case of a banking business transfer, account holders') rights and security;
 - b. whether any policyholder (or, in the case of a banking business transfer, account holder), employee or other interested person will be adversely affected;
 - c. procedural matters, such as whether policyholders (or, in the case of a banking business transfer, account holders) have been notified; and
 - d. the opinion of the FSA (now the Prudential Regulation Authority).

The main consideration for the court, however, is whether the transfer is fair as between the interests of different classes of affected person.¹⁵

- 3.9 Relevant to whether this sanction is granted by the court is the right to participate in proceedings (at section 110 FSMA). According to section 110 FSMA:

On an application under section 107, the following are also entitled to be heard –

¹⁴ (1989) (unreported).

¹⁵ *Re London Life Association Ltd*.

(a) the Authority, and

(b) any person (including an employee of the authorised person concerned or of the transferee) who alleges that he would be adversely affected by the carrying out of the scheme.

3.10 Two areas of legal uncertainty arise from the proposed new section 106(2A).

First, it is unclear whether it is possible to transfer part of a relationship with a particular customer (rather than the entire relationship) under Part VII FSMA. An example of where this uncertainty might arise is where a derivative contract with a particular counterparty is required to be transferred out of the ring-fenced bank and the same counterparty has an amount deposited with the bank which is to remain within the ring-fence. Although, section 106(2A)(a) refers to a banking business transfer of “part of the business carried on by a UK authorised person”, it is unclear from the draft Bill whether part of a relationship with a customer can be transferred from the ring-fenced bank to the non-ring fenced bank. This legal uncertainty might arise in both situations outlined at paragraph 3.6 above (that is, (i) at the outset when a bank is establishing a ring-fence; and (ii) during the life of the ring-fenced bank to transfer business which, if it were maintained in the ring-fenced bank, would cause a ring-fencing contravention).

3.11 Secondly, legal uncertainty arises *ab initio* from the court’s discretion under section 111 FSMA as to whether to grant permission for the transfer of banking business. Again, this legal uncertainty might arise both (i) at the outset when a bank is establishing a ring-fence; and (ii) in the life of the ring-fenced bank.

3.12 If the court were to refuse its permission for the transfer of banking business under section 106(2A), the consequence may be that the business, which is not permitted to be maintained in the ring-fenced bank, would have to be terminated. In the same way, the part of the client relationship which is not permitted to be held in the ring-fenced bank may have to be terminated if it is not possible to transfer part of a relationship with a client under section

106(2A). In practice, both of these areas of legal uncertainty may mean that law firms are unable to give clear legal advice as to transferability. Legal opinions as to the enforceability of arrangements may be required to be qualified. The qualification of legal opinions in this manner could possibly remove the ability of counterparties to UK banks to rely on collateral arrangements and rights of set-off to obtain credit risk mitigation for regulatory capital purposes. This could potentially have the effect during the transition period of upsetting the capital treatment of existing transactions and significantly increasing the regulatory capital costs imposed on counterparties. Equally, UK banks may find during the transition period that entering into new business with counterparties is frustrated (or must be done at a significantly increased cost) as a result of the counterparty being unable to take any benefit by way of credit risk mitigation from collateral or rights of set-off.

3.13 The FMLC considers that the uncertainty surrounding whether part of a relationship with a customer could be transferred under Part VII FSMA could be resolved by introducing grand fathering provisions which carve out those transactions upon which the parties are currently relying and which work alongside a transfer under Part VII. The FMLC is of the view that although this approach would result in a potentially lengthy grand fathering process, it would resolve the uncertainty.

3.14 Alternatively, the provision could require certain relationships to be kept together; either all transferred into the new business or all kept in the continuing one, with permission for the ring-fenced bank (or the non-ring-fenced bank) to run-off any otherwise unpermitted activities it would have as a result of the keep together provisions. The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 (as amended) (the “Safeguards Order”) aims to reduce disruption to a business’s contractual rights and methods of reducing credit risk caused by the existence of partial property transfer powers. One way in which the Safeguards Order achieves this objective is by restricting the transfer of some, but not all, of the protected rights and liabilities between a particular person and a banking institution under a particular set-off

arrangement, netting arrangement or title transfer financial collateral arrangement (section 3(1) Safeguards Order). Similar restrictions could provide greater clarity as to whether part of a relationship with a customer can be transferred under section 106(2A).

- 3.15 The Safeguards Order also identifies the main areas where a transfer under section 106(2A) is likely to result in objections from customers claiming to be “adversely affected” by the transfer (for example, where only part of a customer’s rights and liabilities under a set-off arrangement are to be transferred out of the ring-fenced bank). Including restrictions similar to those in the Safeguards Order might also reduce the number of objections raised to the transfer.
- 3.16 The FMLC considers that there would be less uncertainty if the Court had less discretion to refuse a transfer of banking business carried out under section 106(2A). The FMLC is of the view that the consideration at section 111(3) FSMA (that, in all the circumstances of the case, it is appropriate to sanction the scheme) should be maintained, but that greater certainty could be achieved by introducing a higher standard in section 110(b) FSMA. One way of achieving this certainty would be to amend the drafting so that only those individuals who allege that they would be materially prejudiced (rather than adversely affected, as the current drafting reads) by the carrying out of the scheme have the right to be heard.

4 LOCATION AND HEIGHT OF THE RING-FENCE

- 4.1 The FMLC considers that the draft Bill in its current form does not provide institutions with certainty, or at least predictability, in respect of the ring fencing requirements to enable market participants to understand whether they will be subject to ring-fencing and what the location and height of the ring-fence will be. It delegates the power to determine the existence, location and height of the ring-fence to HM Treasury or the Prudential Regulation Authority and does not provide certainty or predictability as to the exercise of those powers, either initially or by subsequent amendment.

Section 142A

4.2 Draft section 142A of FSMA, set out in section 4 of the draft Bill, provides for exemptions to the ring-fencing requirement to be made by order of HM Treasury. It is assumed that this power is to enable the *de minimis* exemption set out in the proposal, which would exempt all UK institutions with £25 billion or less in deposits from individuals and small to medium-sized enterprises (“SMEs”). Proposed section 142A of FSMA provides that HM Treasury

may exempt a class of UK institution only if the Treasury is of the opinion that the exemption... would not be likely to have a significant adverse effect on the continuity of the provision in the United Kingdom of core services.

It is unclear from the legislation how HM Treasury will exercise its discretion. The reference to core services, which is defined in section 142C to include facilities for payments into and from deposit accounts and overdraft facilities (itself an unclear definition, as discussed above at paragraphs 3.1, 3.2 and 3.3), indicates that a wider array of factors than the size of the deposit book of the relevant institution is relevant: for example, would a small bank which provides significant cash management services or has a role in payment services beyond the taking of deposits be outside the exemption notwithstanding that its deposit base is under the *de minimis* threshold?

4.3 According to the policy overview accompanying the draft Bill (at chapter 2 of the policy document “Sound Banking: delivering reform” dated October 2012), most UK institutions which currently have a banking licence would in practice be exempted from section 142A and/or allowed to carry out deposit-taking in circumstances where it is not a core activity under section 142B. According to the same policy overview, only either (i) existing institutions which have had many of their functions and subsidiaries stripped out in an internal group re-organisation so that they could operate on a ring-fenced basis or (ii) new entities established in a banking group to carry out only ring-fenced activities, would actually be ring-fenced banks.

Section 142B

- 4.4 Similar concerns arise in draft section 142B of FSMA. Sub-section (2) of section 142B establishes deposit-taking as a core activity (to be conducted within the ring-fence, for non-exempt institutions), unless carried on in circumstances specified by order made by HM Treasury. Subsections (3) and (4) of section 142B of FSMA provide that such an order may only be made if HM Treasury is of the opinion that it is not necessary for either of the following two purposes that the relevant activity be a core activity: (a) to secure an appropriate degree of protection for the depositors concerned; and (b) to protect the continuity of the provision in the United Kingdom of services provided in the course of taking deposits. Both the white paper published by HM Treasury and the Department for Business Innovation and Skills in June 2012 (“Banking reform: delivering stability and supporting a sustainable economy”) and the policy document (“Sound Banking: delivering reform”), however, suggest that taking deposits from (i) an individual with assets above a certain level and (ii) a company or other business with a turnover above a certain level, will be excluded from being a core activity under section 142B. The effect of this is that a non-ring-fenced bank can carry on these activities.
- 4.5 Setting aside the implicit assumption that a ring-fenced bank will confer a greater degree of protection on depositors than a non-ring-fenced bank, it is unclear what amounts to an “appropriate” degree of depositor protection for the purposes of the first test at section 142B(4) of FSMA. The second test, which addresses the continuity of the provision of deposit-taking services generally, is obscure and arguably satisfied where the deposit-taking activity in question is capable of transfer to a private sector purchaser or bridge bank under the Banking Act 2009.
- 4.6 Subsections (5) and (6) of section 142B provide for HM Treasury to extend the core activities definition to include regulated activities other than deposit-taking. Again, the test by reference to which the extension may occur is two-fold: that (a) an interruption in the provision of services provided in the United Kingdom in the carrying on of the relevant activity could adversely affect the

stability of the UK financial system or a significant part thereof and (b) the continuity of those services can more effectively be protected by treating the activity as a core activity.

- 4.7 Again, if one accepts that the effect of ring-fencing is to produce a greater degree of protection of the activities housed within the ring-fence, it is hard to see how any mainstream regulated activity would not satisfy both tests. Taking custody as an example, it is clear that an interruption in the provision of custody services in the UK could adversely affect the stability of the UK financial system: on the assumption that a ring-fenced custodian provides greater protection than a non-ring-fenced one, the test will be satisfied. One may accept that HM Treasury will not in fact use its discretion to seek to make custody a core activity, but the statutory test provides no clarity as to why it should not. The FMLC is of the view that the statutory test is insufficiently clear to guide HM Treasury in the exercise of its discretion.

Section 142D

- 4.8 Proposed section 142D of FSMA provides for a push-out of prohibited services from the ring-fence. Section 142D treats as an “excluded activity” the regulated activity of dealing as principal in investments, subject to the power of HM Treasury to (i) set out circumstances in which dealing is not an excluded activity and (ii) provide for any other activity to be an excluded activity. The powers to carve out and add to the scope of excluded activities essentially empower HM Treasury to define the excluded activities independently (albeit subject to certain limitations on their ability to extend scope).
- 4.9 As with the regulated activity of accepting deposits, the regulated activity of dealing as principal in investments draws on the definitions and scope set out in the Financial Services and Markets Act (Regulated Activities) Order 2001¹⁶ (the “RAO”). The definition is subject to numerous exclusions and qualifications, as well as certain overlapping provisions under the Markets in Financial Instruments Directive (2004/39/EC) by virtue of Article 4(4) of the

¹⁶ 2001 No. 544.

RAO (the so-called “MiFID override”). The FMLC questions whether this is an appropriate starting point for defining excluded activities since, based on the report produced by the ICB, there will be limited correlation between the regulated activity and the proprietary dealing activities sought to be prohibited within ring-fenced banks. Using the regulated activity as a starting point would result in a long list of detailed exclusions, as well as a further list of additional activities which are not regulated activities (on the grounds that they fall within exclusions under the RAO) but which are to be prohibited. One example of this would be dealings in securities which are excluded from the regulated activity as dealing as principal under Article 15 of the RAO, or intra-group dealings in investments excluded by Article 69, which will presumably be within the scope of the excluded activities. This position will be further complicated by the need to carve out permitted treasury and other “ancillary activities” permitted by the ICB report. Further, given that this legislation is amended heavily and often, the FMLC considers that, if it is nonetheless to be used as a starting point, an authoritative consolidated instrument setting out the current definition of “investments” (and accompanied by any proposed changes) would be of assistance.

- 4.10 The FMLC is of the view that exceptions to 142D are also required to clarify that the following matters are possible (which it is assumed is the policy intention):
- a. The RAO contains provisions which ensure that a company issuing its own shares or loan instruments is not treated as trading as a principal. It appears that there is no equivalent provision for making loans to others (i.e. making an investment in the borrower) or taking deposits. The FMLC is of the view that an exception covering these activities is required to enable ring-fenced banks both to provide overdraft facilities (a core service) and to carry out their core activity.
 - b. Banks frequently lend on a secured basis. In taking security from customers, more than one legal method would involve taking assignments or acquiring an ownership interest in various forms of assets owned by

customers (for example, shares, loans or contractual payments). Based on the current drafting of the draft Bill, it appears that there is a risk of taking security being regarded as involving trading in securities as a principal. The FMLC considers that it should be clarified that lending on a secured basis and enforcing security rights (which could, for example, include the exercise of the power of sale in respect of securities charged to a ring-fenced bank) are not prohibited.

Section 142E

4.11 Section 142E of FSMA provides for a power of HM Treasury to impose various prohibitions on ring-fenced banks by order. The tests by reference to which the power to prohibit are drawn up are the same as those in section 142D and some of the same points apply as made in respect of that section.

5 CONCLUSION

5.1 The uncertainty referred to above risks leaving market participants unable to prepare for transition. The FMLC is of the view that there is insufficient detail on the regime's architecture to enable meaningful planning. By way of example, it is unclear based on the current drafting whether ring-fenced banks will be able to deal with insurance companies for such purposes as insuring their assets, offering insurance products to their customers as agents for an insurance company and providing current account services to an insurance company.

5.2 In order to bring clarity to the process, the FMLC considers that:

- a. a timetable should be adopted (whether or not in the draft Bill) to provide certainty on the major open questions in good time to enable an orderly transition to ring-fencing; and
- b. a forum is needed to provide an open and transparent dialogue on the unresolved legal issues within the proposals. The FMLC would recommend the creation of a panel under the Bill, similar to the Banking Liaison Panel under the Banking Act 2009 (or an extension of the remit of that panel), to provide a forum for stakeholders, the Government and

regulatory authorities to ensure that the detail contained in secondary legislation and/or regulation is clear, properly understood and workable. Such a panel would also be a useful mechanism for providing feedback on the effects of ring-fencing post-implementation.

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¹⁷ Note that Members act in a purely personal capacity. The names of the institutions that they ordinarily represent are given for information purposes only.