SLAUGHTER AND MAY/

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UK BANK RING-FENCING: WORTHWHILE REFORMS?

WHAT HAS HAPPENED?

On 11 November 2024, a draft statutory instrument amending the UK bank ring-fencing regime was laid before Parliament (the Draft SI). On the same day, HM Treasury published a response to its September 2023 consultation on 'near-term reforms' to the regime. HM Treasury undertook this consultation in response to the 2021-2022 independent ring-fencing and proprietary trading review led by Sir Keith Skeoch.

The contents of the Draft SI are broadly consistent with the proposals of the Skeoch review and the 2023 consultation, as follows:

(a) ***Threshold reforms:*** A UK bank is currently subject to the ring-fencing regime if, together with any other UK bank(s) in its group, it has "*core deposits*" (broadly, retail and small business deposits) of more than £25 billion, averaged over a prescribed calculation period. The Draft SI increases this threshold to £35 billion. The Draft SI also introduces a secondary threshold to exempt retail-focused banks with trading assets of ≤10% Tier 1 capital from the ring-fencing regime (calculated on a UK consolidated basis), except where they are a member of a group that the Financial Stability Board has designated as a Global Systemically Important Bank (***GSIB***).

(b) ***Architectural reforms:*** The Draft SI will allow ring-fenced banks (***RFBs***) to establish branches and subsidiaries and to hold ≥20% minority investments in companies incorporated outside the UK and EEA. The Draft SI also provides for a new four-year M&A transition period to prevent UK banks entering the regime for the first time immediately upon, and as a result of, an M&A transaction.

(c) ***Reforms to permitted activities:*** The existing ring-fencing regime imposes significant restrictions on the permitted activities, products and services of RFBs. The Draft SI seeks to ease some of these restrictions, including by (i) permitting RFBs to make minority investments in SMEs, (ii) to a limited extent, liberalising the prohibition on exposures to relevant financial institutions (***RFIs***), (iii) broadening RFBs' ability to undertake debt restructuring for borrowers in financial difficulty and (iv) widening the range of hedging activities in which RFBs can engage.

We summarise the anticipated impact of these reforms in the table below, and comment on some of the implications. The reforms are grouped by the topics listed above.

The reforms in the Draft SI do not represent a wholesale overhaul of the ring-fencing regime. For most banking groups that will remain subject to the regime, the reforms are therefore likely to have a modest, albeit broadly beneficial, impact. By contrast, for retail-focused banking groups, and other banking groups whose UK retail deposits are less than £35 billion (but close to or above £25 billion), they will fall outside (or remain outside) the ring-fencing regime entirely, and in some cases indefinitely. These groups therefore stand to benefit most from the reforms. There is a concern, however, that unless the PRA takes a firm view on how the calculations that are required for the new trading assets exemption are to be done and how it will supervise banking groups that are relying on that exemption, the exemption will introduce new uncertainty.

It is anticipated that these reforms will take effect as soon as late January 2025, subject to Parliamentary approval and a 22-day implementation period for the substantive reforms to come into force after that.

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Topic	**Summary of reform**	**Comments**
Threshold reforms		
Increase to primary 'core deposits' threshold from £25 billion to £35 billion	A UK deposit-taker will not be an RFB unless, together with any other UK deposit-taker in its group, it has 'core deposits' exceeding £35 billion, increased from £25 billion. This figure should be calculated as an average at quarter ends over a three-year rolling period in accordance with the existing ring-fencing legislation (which will not be amended).	The increase to the core deposits threshold is perhaps the most striking and noteworthy update to the regime. For some stakeholders, the proposed £10 billion increase is a welcome and appropriate development. The Government considers that this reform will "*encourage inward investment into the UK as new entrants to the UK banking market will have more room to grow*", and that an appropriate balance has been struck between financial stability and competition considerations. However, others consider that the increase will disproportionately benefit banking groups headquartered outside of the UK, in turn having a negative effect on the competitiveness of UK headquartered banking groups. In any case, given that 'core deposits' are calculated in accordance with a three-year rolling average, UK deposit takers which are not currently RFBs will have scope to increase their core deposits without becoming subject to the regime for some time.
Introduction of a secondary threshold to exempt retail-focused banking groups	The Draft SI introduces a secondary threshold - the trading assets exemption - into the regime. As a result, where a UK deposit-taker has trading assets which do not exceed 10% of its tier 1 capital, it will be exempt from being an RFB (even if the core deposits threshold noted above is exceeded). For UK headquartered banking groups, both trading assets and tier 1 capital will be measured on a consolidated basis - so including overseas operations where relevant. The position is, however, different for non-UK headquartered banking groups (see next column). Members of a group which is a GSIB will not be allowed to rely on this exemption.	This reform will allow UK banking groups that have no - or relatively low value - trading assets to be exempt from the ring-fencing regime. UK banking groups which carry out no or very limited investment banking-type trading activities will therefore benefit from a lowered compliance burden, in recognition that the financial stability benefits associated with the ring-fencing regime are less relevant to these firms. In the short-term, the Government expects two of the 13 current RFBs to cease to be an RFB once the Draft SI comes into force. It is perhaps the longer-term impact of the new trading assets exemption, however, which could prove most significant for the UK banking sector. The new exemption would permit retail-focused UK challenger banks to continue on their growth trajectory without facing the prospect of ring-fencing compliance, giving them greater opportunities to scale their current strategy. Some criticism has been levied at the divergent approach to the threshold calculations - these are calculated differently depending on whether a banking group is headquartered in or outside of the UK. For UK headquartered banking groups, both trading assets and tier 1 capital will be measured on a consolidated basis in accordance with the UK Capital Requirements Regulation, therefore taking into account the activities of the group as a whole. Conversely, for non-UK headquartered banking groups, only the activities of any UK consolidation sub-group(s) will be relevant, in addition to the activities of any branches authorised in the UK (where not already included in the calculations). As a result, trading assets in a direct non-UK subsidiary of a US-incorporated bank holding company, for

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		example, would fall outside of the calculation. It remains to be seen whether this presents non-UK headquartered banking groups with practical (rather than simply theoretical) opportunities for structural arbitrage. It is also presently unclear how the PRA would exercise its existing supervisory powers in a scenario if a non-UK headquartered banking group with a significant (>£35 billion core deposits) UK retail bank subsidiary sought to evade the UK ring-fencing regime by booking trading assets outside its UK consolidation group.
Architectural reforms		
Allow RFBs to establish operations globally, subject to PRA rules	The existing restrictions on RFBs establishing branches and subsidiaries (or having participating interests (20%+ shareholding)) in companies incorporated outside the UK and the EEA will be removed.	The removal of the current geographic prohibition on establishing and maintaining overseas branches, subsidiaries and 20%+ shareholdings in companies is in line with the general liberalising theme of the reforms. In particular, the Government has recognised the existing powers of the PRA to impose requirements and oversee operations of RFBs in overseas jurisdictions, as well as the Bank of England's ability to do so from a resolution planning perspective. The Government considers that this should, in turn, mitigate any potential risks arising from this reform. The PRA previously published a consultation on managing risks arising from overseas subsidiaries and branches (PRA CP20/23), with the amendments to PRA rules and guidance proposed to coincide "as closely as practicable" with the removal of this legislative prohibition. RFBs should review how PRA policy develops in this area. In addition, the Draft SI, in correcting an unintended consequence of the Government's initial legislative proposal, provides that a deposit will only be a "core deposit" when it is held in a UK account. Deposits made in non-UK branches of UK banks will neither be core deposits nor count towards the £35 billion core deposits threshold.
New four-year M&A transition period	The regime will include a four-year transition period for UK non-ring-fenced banks (***NRFBs***) to comply with the ring-fencing regime where they, or the NRFB's parent undertaking, are acquired by a ring-fenced banking group.	Currently ring-fenced banking groups which acquire a UK deposit-taker that is an NRFB must ensure that, immediately at completion, the target – providing it accepts core deposits -fully complies with the full suite of ring-fencing requirements. This imposes significant practical hurdles, since all activities, business lines and exposures of such an NRFB target that are prohibited under the regime must be wound down before completion. As such, it is possible that this reform in particular may prompt an uptake in M&A within the UK banking sector. Similarly, the Draft SI introduces a similar four-year transition period in relation to the trading assets exemption where a UK deposit-taker is acquired. Therefore, when combined with the existing four-year grace periods in the regime – which apply to a transfer of shares pursuant to the Bank of England's resolution powers, and also when a banking group crosses the core deposit thresholds through M&A – the effect will be that, in all scenarios, a UK deposit

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		taker will have four years to comply with the regime if the reason for it becoming an RFB was an acquisition. The Draft SI does not affect the existing exemption from the requirement to treat a UK NRFB as an RFB when it is acquired by a group that is subject to the ring-fencing regime and the acquisition takes place by exercise of the Bank of England's resolution powers.
Reforms to permitted activities		
Minority investments in UK SMEs	New measures will be introduced to facilitate minority investments by RFBs in UK SMEs and in funds that invest predominantly in UK SMEs, as well as the acquisition of equity warrants issued by UK SMEs (in each case subject to quantitative limits).	RFBs are already permitted to acquire a majority shareholding interest or, if the target is not an RFI, a participating interest (20%+ shareholding) in any UK or EEA company under the existing rules (subject to limited exemptions). These amendments extend the range of equity financing options available to UK SMEs and reiterate the clear encouragement from Government for private sector investment in the UK economy. However, the real impact of these reforms for UK SMEs may be somewhat tempered for banking groups with NRFBs that are currently permitted to make these investments.
Liberalisation of RFI exposure rules	Currently, RFBs are subject to strict rules which prohibit them for incurring exposures to RFIs (such as other banks, insurers or investment firms), unless an exemption applies. The changes will permit an RFB to incur exposures to SMEs and introduce a new *de minimis* threshold permitting an RFB to incur exposures of up to £100,000 to a single RFI at any one time, without breaching this prohibition.	While the new threshold is not intended to bring about sweeping reforms to the existing prohibition, it should avoid the need for RFBs to report insignificant, technical RFI exposures and should therefore reduce the compliance burden on both RFBs and the PRA.
Debt restructurings	The Draft SI provides that an RFB may acquire shares, debentures and instruments when they are issued as part of a debt restructuring where the borrower has encountered or is likely to encounter financial difficulties and the restructuring seeks to mitigate the effects. The amendments also provide additional flexibility – for example, by permitting the RFB to acquire further shares after the original acquisition to prevent its shareholding being diluted.	RFBs are permitted to engage in debt for equity swaps under the existing legislation. This allows a bank to accept equity (e.g., shares) in a company in return for the bank releasing the company from a debt. However, industry concerns had been raised as to the narrow scope of the existing exemption which permits only direct exchanges, but which does not necessarily apply in the context of more complex, wider debt restructurings. This change seeks to broaden the scope of activities that RFBs may carry on in the context of restructurings.

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Reforms for NRFBs	NRFBs will benefit from a new “grace period” of 12 months to move customers that are no longer considered to be an RFI, along with their deposits, to an RFB. In addition, NRFBs will no longer be required to provide qualifying organisations (including larger corporates) and their group members with a “notice of declaration” as part of the onboarding process.	Under the current rules, when a depositor of an NRFB ceases to be an RFI, their deposit would become a core deposit and the NRFB would immediately be prohibited from retaining that deposit, unless an exemption applies. When introduced, this reform would provide the NRFB with a period of time to transition such a depositor to an RFB. This reform, and the removal of the “notice of declaration” requirements, should ease the compliance burden on NRFBs.
Proposal to permit RFBs to offer inflation swap derivatives	This reform will allow an RFB to offer inflation swap products to its clients, subject to the same conditions and limits as apply to other derivatives that RFBs are allowed to offer. The Draft SI limits the tenor of any permitted inflation swap to 30 years.	This means that clients of an RFB will be able to hedge inflation risks with the RFB, helping them to protect their business from inflation. Inflation swap derivatives are commonly used in project finance and other transactions and, before this reform, RFBs were required to request the NRFB in their group (if any) to enter into the trade with the client, creating unnecessary friction according to the Government.
Hedging of mortality and longevity risk	RFBs will be permitted to deal as principal and/or to incur exposures to RFIs for the purpose of managing the mortality risk or longevity risk of themselves and/or certain other entities.	This reform was introduced to support competition as it will allow RFBs to enter into lifetime mortgages and equity release mortgages with its customers (among other things). The current position was previously deemed to be commercially unviable as it prevents RFBs from effectively mitigating the key risks associated with these products.
Test trades and share dealing errors	RFBs will be allowed to deal as principal for the purpose of undertaking test trades in certain securities. "Test trades" are trades entered into for the purpose of testing new products or services. In addition, RFBs will be permitted to "deal as principal" for the purpose of correcting the failure of a securities trade which is due to an error.	The Government anticipates that permitting RFBs to deal as principal in test trades will help facilitate the launch of new products and services. Through this, and the express permission to deal to correct errors in trades, the reforms also seek to improve the overall functioning of the ring-fencing regime. This will, for example, make it easier for RFBs to run retail share trading businesses on an agency brokerage basis.
Trade finance activities	The Draft SI clarifies somewhat the extent to which RFBs are permitted to incur RFI exposures in connection with their trade finance activities.	RFBs are already permitted to incur exposures to RFIs to support trade finance activity. However, there was a degree of legal uncertainty as to the range of trade finance products that RFBs are permitted to facilitate (such as standby letters of credit and bills of exchange). This reform seeks to clarify the legal position and to better reflect market practices.
The Draft SI cannot be amended by, but only becomes law subject to the approval of, the Houses of Parliament. On average, this approval process takes six to seven weeks from when the draft statutory instrument is laid before Parliament. It is anticipated that the Draft SI could come into force as soon as late January 2025.		

CONTACTS

Jan Putnis
PARTNER

Nick Bonsall
PARTNER

David Shone
PARTNER

Sabine Dittrich
SENIOR COUNSEL

Kristina Locmele
SENIOR COUNSEL

Charlotte Asher
ASSOCIATE

Natalie Barnes
ASSOCIATE

Heather Broadbent
ASSOCIATE

Andres Chau
ASSOCIATE

Ben Goldstein
ASSOCIATE

Tabitha Harris
ASSOCIATE

David Kasal
ASSOCIATE

Rufus Sachdev-Wood
ASSOCIATE

Martijn Stolze
ASSOCIATE

David Verghese
ASSOCIATE

Jay Welch
ASSOCIATE

Connor Williamson
ASSOCIATE

Janet Wong
ASSOCIATE

Selmin Hakki
PSL COUNSEL

Emily Bradley
PSL COUNSEL

Charles Randell
SENIOR CONSULTANT