

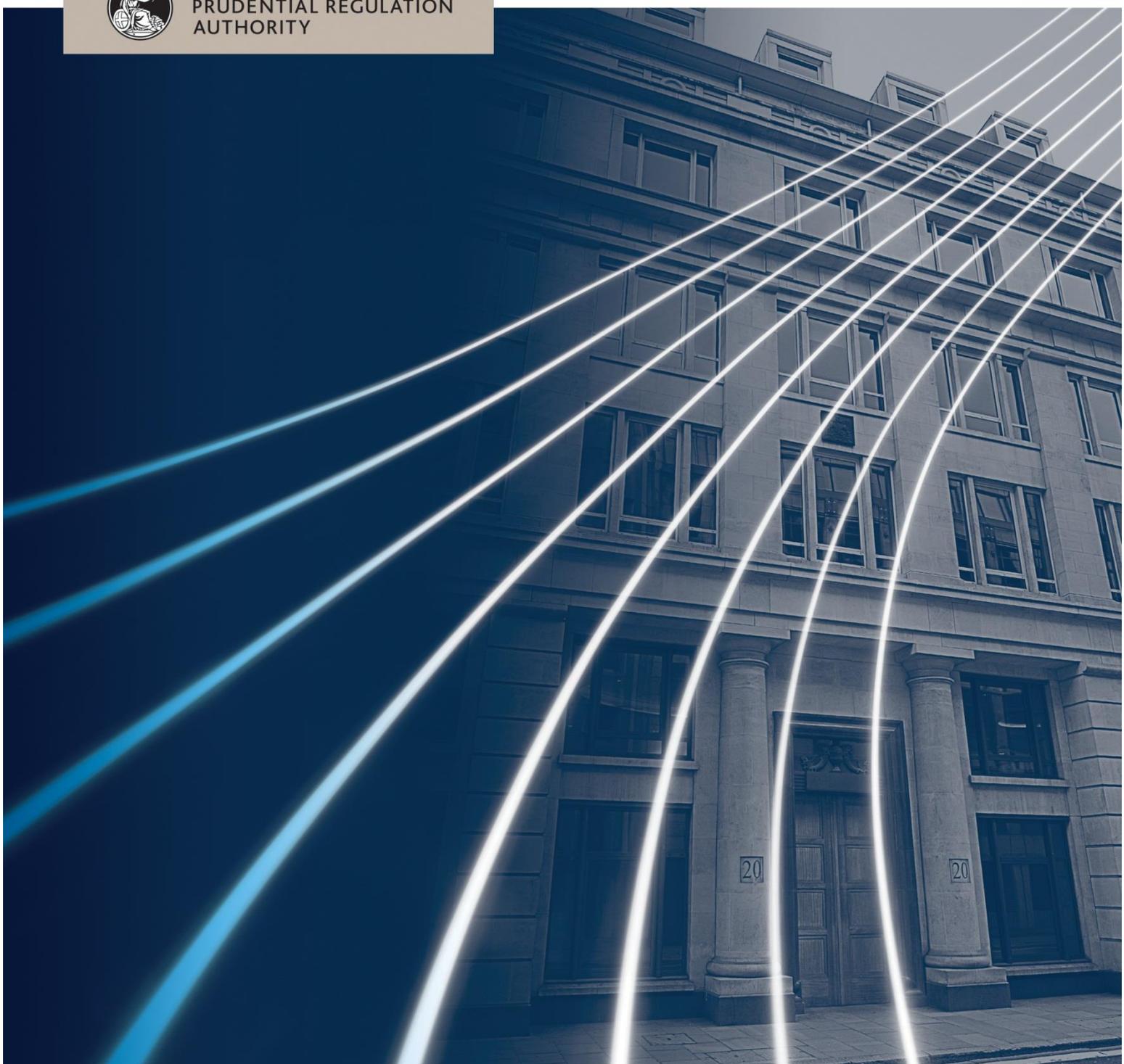
Statement of Policy

The implementation of ring-fencing: the PRA's approach to ring-fencing transfer schemes

March 2016



BANK OF ENGLAND
PRUDENTIAL REGULATION
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1 Background to ring-fencing

1.1 In response to the financial crisis, a number of domestic and international reforms to bank regulation have been introduced or are currently being implemented. Many of these reforms seek to improve the resilience and resolvability of banks, including through making changes to their structure.

1.2 The Financial Services (Banking Reform) Act 2013 (the Act) contains provisions that 'ring-fence' core activities to ensure that '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'.¹ The Act defines 'core activities' as the regulated activity of accepting deposits and requires that banking groups which undertake core activities do so in ring-fenced bodies (RFBs). Institutions that have more than £25 billion of 'core deposits' – broadly those from individuals and small businesses - on average, over a period of three years, will be subject to ring-fencing requirements.² The Government has stated that the ring-fencing regime comes into effect on 1 January 2019.

1.3 The Act also prohibits RFBs from undertaking 'excluded' activities and specifies that this includes dealing in investments as principal.

1.4 This is intended to protect retail banking from risks unrelated to the provision of that service and help ensure that banking groups can be resolved in an orderly manner, thereby avoiding taxpayer liability and thereby maintaining cash flows and the continuous provision of necessary retail banking services.

2 The definition and purpose of ring-fencing transfer schemes (RFTS)

2.1 The Act created an additional form of transfer of business known as a RFTS. It is designed to enable banking groups that will include an RFB to restructure their businesses to comply with the ring-fencing requirements.

2.2 The PRA expects the RFTS process to facilitate a variety of types of transfers. For example, some transfers may be for core activities to be moved across to a RFB. Others may be transfers of 'excluded' activities from RFBs into other authorised entities or transfers to non-authorised entities.

3 The RFTS process

3.1 In order for an RFTS to be sanctioned, an application must be made to the court. To aid the court in its decision as to whether to sanction the transfer, the court must be provided with a scheme report to be authored by a person appearing to the PRA to have the skills necessary to enable a person to make a proper report ('a skilled person').

3.2 The PRA must approve the skilled person, in consultation with the FCA. In most cases the PRA would anticipate that the firm would nominate the skilled person; this is discussed in further detail in section six.

1 Section 142H(4a), FSMA

2 As set out in the secondary legislation made by HM Treasury 'The Ring-fenced Bodies and Core Activities Order 2014': www.legislation.gov.uk/uksi/2014/1960/contents/made

3.3 The scheme report must address a question specified in the legislation as to '(a) whether persons other than the transferor concerned are likely to be adversely affected by the scheme, and (b) if so whether the adverse effect is likely to be greater than is reasonably necessary in order to achieve whichever of the purposes mentioned in section 106B(3) is relevant' ('the statutory question').¹ The purposes are specified in paragraph 5.4.

3.4 The PRA must approve the form of the report, in consultation with the FCA.

3.5 The PRA must, if it is satisfied that the application may properly proceed, consent to the firm's application to the court. This is a new requirement for the PRA that does not apply for banking business transfers. In deciding whether to give consent, the PRA must have regard to the scheme report.

3.6 The PRA must also issue two certificates to the court. The first certifies the PRA's approval to the application. The second certificate issued by the PRA is to certify that the transferee will possess adequate financial resources. The court may not sanction an RFTS unless the PRA has certified that, taking the proposed transfer into account, the transferee (ie the receiving entity) possesses, or will possess before the scheme takes effect, adequate financial resources.

3.7 If the transferee is authorised in an EEA state other than the United Kingdom then the PRA will also need to issue a third certificate to the court, certifying that:

- (i) the home state regulator of the transferee has been notified of the proposed scheme; and
- (ii) a period of three months beginning with the notification has elapsed.

3.8 The key stages of the RFTS process are set out below.

- (i) The PRA will have initial dialogues with the firm proposing the RFTS to understand the scope, timetable and nature of the transfer as well as the nominated skilled person.
- (ii) The PRA may wish to have preliminary discussions with the nominee about the transfer before the PRA determines if they are suitably qualified to undertake the task required of the skilled person. The PRA will then approve or nominate the skilled person in consultation with the FCA.
- (iii) The PRA, in consultation with the FCA, will approve the form of the scheme report.
- (iv) The PRA will, if appropriate (having regard to the scheme report and other relevant matters), consent to the application to the court.
- (v) A Directions hearing will take place where the court sets out a timetable for the applicant² to notify the public of the RFTS application and receive any written submissions from persons alleging they would be adversely affected by the scheme.
- (vi) The PRA will take account of any representations made to the court and if appropriate, will confirm its approval of the application by the issue of a certificate to the court.

¹ As stated in section 106B(3) of The Financial Services and Markets Act 2000

² The applicant is usually the transferor, transferee (or both) submitting the RFTS application to the court in order to effect the transfer

- (vii) The PRA is required, if appropriate, to issue a certificate as to financial resources to the court. Where the transferee is an FCA solo regulated entity, the FCA will issue the certificate of financial resources. Where the transferee is authorised in an EEA state other than the United Kingdom, the home state regulator will issue the certificate as to financial resources.
- (viii) Where the transferee is an EEA firm, a certificate will be provided by the PRA to the court certifying that the home state regulator of the transferee has been notified of the proposed scheme and has either responded or the period of three months has elapsed. The home state regulator will also be engaged at an early stage in the process. In all cases, EEA regulators will be notified of the proposed RTFS.
- (ix) The court decides whether to sanction the RFTS and issue order(s) to effect the RFTS from a specified date.

The regulators

3.9 The PRA and FCA (the regulators) will work jointly with one another throughout each individual RFTS process in pursuit of the objectives of the regulators and to ensure our decision-making processes are conducted in an appropriately coordinated manner. This engagement will include the PRA consulting the FCA as set out in section 3D of FSMA. The FCA has also published guidance on its approach to RFTS.

3.10 FSMA¹ also prescribes certain statutory functions in relation to RFTS for both the PRA and FCA. In accordance with FSMA, the PRA and the FCA maintain a Memorandum of Understanding² which describes each regulator's role in relation to the exercise of its functions under FSMA relating to matters of common regulatory interest and how each regulator intends to ensure the co-ordinated exercise of such functions.

3.11 The PRA will lead the process for the RFTS. As described above, the PRA will also be responsible for specific regulatory functions connected with RFTS applications including the provision of certificates under section 111 of FSMA. The only exception to this is when the transferee is an FCA solo regulated entity. In this instance, the FCA will issue the certificate of financial resources to the court.

3.12 Both the PRA and the FCA³ are entitled to be heard at the proceedings. The two regulators may also provide the court with written representations setting out their views on the proposed transfer scheme, for example, by way of a report to the court. The PRA will decide in relation to each RFTS whether it is necessary or appropriate for it to prepare a report, considering its objectives and other relevant matters.

3.13 Transfers may have both positive and negative effects on persons other than the transferor. A key concern for the PRA will be to satisfy itself that persons other than the transferor have adequate information and a reasonable time within which to determine whether or not they are adversely affected and, if adversely affected, whether to make representations to the court. When reaching its view, the PRA will act in a way it considers most appropriate to advancing its own statutory objectives. The FCA also has a particular interest in the publication and notification of customers and the PRA will engage closely with the FCA on this.

1 As stated in Part VII of FSMA

2 <http://www.bankofengland.co.uk/about/Documents/mous/prastatutory/moufcapra.pdf>

3 The FCA right to appear in court is limited to where the transferee is an authorised person as set out in section 110(4)(b) of FSMA

4 Initial steps

4.1 When a firm is considering undertaking an RFTS it should approach the regulators at an early stage. Early dialogue with the regulators will enable a realistic timetable to be established.

4.2 There will be close and frequent dialogue between the PRA, the firms, the nominated skilled person, the FCA and any home state regulator (where a transferee includes a firm authorised by an EEA state other than the UK) during which the scope and content of the scheme report will develop.

4.3 Before the nominated skilled person is approved by the PRA, they should avoid undertaking excessive preliminary work which may compromise or be perceived to compromise their independence.

4.4 The initial documentary information on the scheme should be provided to the PRA, shared with the FCA, and should include the broad outline of the RFTS including a provisional timetable. Firms should undertake and share their own assessment on the statutory question (detailed in section 5) in the course of their planning for the implementation of the ring-fencing regime. This analysis should be shared with the skilled person.

5 The scheme report

The statutory question

5.1 A scheme report must accompany an application to the court to approve an RFTS. This report must be made in a form approved by the PRA, following consultation with the FCA.

5.2 Where one RFTS application will cover multiple transfers, the PRA would expect only one scheme report to be commissioned to cover all of the transfers within the application. This scheme report must address the statutory question for each transfer.

5.3 The legislation requires that the scheme report address the statutory question of '(a) whether persons other than the transferor concerned are likely to be adversely affected by the scheme, and (b) if so, whether the adverse effect is likely to be greater than is reasonably necessary in order to achieve whichever of the purposes mentioned in section 106B(3) is relevant'.

5.4 The purposes outlined in section 106B(3) are as follows:

- (i) enabling a UK authorised person to carry on core activities as a ring-fenced body in compliance with the ring-fencing provisions;
- (ii) enabling the transferee to carry on core activities as a ring-fenced body in compliance with the ring-fencing provisions;
- (iii) making provision in connection with the implementation of proposals that would involve a body corporate whose group includes the body corporate to whose business the scheme relates becoming a ring-fenced body while one or more other members of its group are not ring-fenced bodies; and

- (iv) making provision in connection with the implementation of proposals that would involve a body corporate whose group includes the transferee becoming a ring-fenced body while one or more other members of the transferee's group are not ring-fenced bodies.

5.5 The ring-fencing provisions are defined as the ring-fencing rules and the duty imposed as a result of section 142G. This encompasses the primary and secondary legislation as well as PRA rules and supervisory statements that relate to structural reform.

5.6 By 'persons other than the transferor', the PRA would expect the skilled person to consider at least the implications for depositors, customers and counterparties of the transferor, irrespective of whether their relationships are being transferred. These persons should include legal persons such as other companies in the transferor's group, whether or not they are ring-fenced bodies. We consider the skilled person can, therefore, bring the interests of group companies into account when answering the question in s 109A(4) FSMA. More generally, the skilled person should also consider whether there are other persons who could be affected adversely by the scheme, the impact on whom may need to be assessed too. Given the size and complexity of the banks expected to make use of RFTS, the skilled person may wish to consider the effects of the scheme on material groups of persons where it would be impractical otherwise to assess the effects on all individual persons.

5.7 In addressing part (a) of the statutory question, if the skilled person does not identify that any material groups of persons other than the transferor are likely to be adversely affected then the skilled person does not need to address part (b) of the question in relation to these persons.

5.8 In order for the skilled person to judge whether material groups of persons other than the transferor are likely to be adversely affected, the PRA would expect the skilled person to consider at least the prudential conditions of the transferee relative to the transferor. This is to assess whether those groups of persons being transferred are affected adversely as a result of becoming connected to a riskier entity than they were connected to prior to the transfer. In making this judgement, the skilled person may consider whether the transfer results in a material deterioration in:

- (i) the quality of the **operational continuity arrangements** of the entities to which those persons are exposed or connected and the ability of the entities **to continue to provide core services** to those persons;
- (ii) the **capital** position of the entities to which those persons are exposed or connected on a risk weighted and leveraged basis;
- (iii) the **liquidity and funding** position of the entities to which those persons are exposed or connected;
- (iv) the **business-model viability and sustainability** of the entities to which those persons are exposed or connected;
- (v) the quality of the **governance arrangements** of the entities to which those persons are exposed or connected;
- (vi) **the ability of the group to be resolved** and the strength of resolution planning in place;
- (vii) the **quality of the risk management and the systems and controls** of the entities to which those persons are exposed or connected;

(viii) the robustness of **recovery planning**; and

(ix) the position of persons other than the transferor in the **creditor hierarchy**.

5.9 In addressing part (b) of the question and assessing whether the adverse effects identified in part (a) are reasonably necessary, the skilled person should consider whether there are alternative group arrangements that would still meet the purposes specified in s106(B) but that would have materially fewer adverse effect on groups of persons other than the transferor. This would help the skilled person then to assess whether the effects of the scheme on those persons are greater than is reasonably necessary.

5.10 There are other points that the skilled person should consider when authoring the scheme report:

- (i) The skilled person should assess the scheme in its entirety including those elements of the transfer that are mandatory to meet the ring-fencing purposes.
- (ii) Given the breadth of the statutory question, the skilled person may wish to consider only material adverse effects.
- (iii) The skilled person should consider the ability of persons other than the transferor to bear or mitigate adverse effects.
- (iv) The examination of adverse effects should not be limited to a point in time but instead should be considered from the point the scheme is implemented.
- (v) The skilled person should consider to what extent it is appropriate to rely on the firm's data and what data testing may need to be undertaken.

5.11 It should be noted that this is only a guide to approaching the statutory question and the skilled person may determine, upon consideration, that not all of these topics are applicable to a specific RFTS.

5.12 The PRA recognises the list of topics in paragraph 5.8 may not be relevant for every transfer. As such the skilled person may wish to consider particular matters relating either to the scheme or persons connected to the transfer not listed above

5.13 The skilled person may also need to examine the conduct implications of the transfer for persons other than the transferor and should hence consider any equivalent guidance provided by the FCA in this area.

Other matters that may be included in the scheme report

5.14 The PRA expects that there are some common elements that should be included in any scheme report:

- (a) who appointed the skilled person and who is bearing the costs of that appointment;
- (b) confirmation that the skilled person has been approved or nominated by the PRA;
- (c) a statement of the skilled person's professional qualifications and descriptions of the experience that makes them appropriate for the role;

- (d) whether the skilled person, or their employer, has, or has had, direct or indirect interest in any of the parties which might reasonably be thought to influence his independence, and details of any such interest as well as steps taken to mitigate this;
- (e) the scope of the report;
- (f) the purpose of the scheme;
- (g) a summary of the terms of the scheme in so far as they are relevant to the report;
- (h) what documents, reports and other material information the skilled person has considered in preparing the report and whether any information that they requested has not been provided; and
- (i) the extent to which the skilled person has relied on:
 - i. information provided by others;
 - ii. the judgment of others; and
 - iii. why, in their opinion, such reliance is reasonable.

5.15 The purpose of the scheme report is to aid the court in reaching a decision as to whether to sanction the transfer. The skilled person therefore has a duty to the court. However reliance will also be placed on the scheme report by persons other than the transferor including the regulators. The amount of detail that is appropriate to include will depend on the complexity of the scheme, the materiality of the details themselves and the circumstances.

5.16 Where the transfer forms part of a wider corporate restructuring, it may not be appropriate to consider the transfer in isolation and the skilled person should seek sufficient explanations on corporate plans to enable them to understand the wider picture. Similarly, the skilled person will also need information on the operational plans of the transferee and, if only part of the business of the transferor is transferred, of the transferor. These will need to have sufficient detail to allow them to understand in broad terms how the business will be run.

5.17 When the PRA has approved the form of a scheme report, it will provide confirmation of this to the approved skilled person and the firm.

6 The skilled person

Qualifications

6.1 FSMA¹ requires that a scheme report may only be made by a person:

- (i) appearing to the PRA to have the skills necessary to enable the person to make a proper report; and
- (ii) nominated or approved for the purpose by the PRA.

6.2 The PRA expects the skilled person making the scheme report to be a person who:

1 Section 109(2) FSMA

- (i) is independent, insofar that any direct or indirect interest or connection he/she or his/her employer has (or has had) in either the transferor or transferee should not be such as to prejudice his status in the eyes of the court and that this should remain the case throughout the RFTS process; and
- (ii) has relevant knowledge, both practical and theoretical, and experience of the types of business transacted by the transferor and transferee.

6.3 The principles set out in *PRA Supervisory Statement SS7/14* also apply to the skilled person.¹

6.4 The PRA considers that a firm's external auditor is eligible to be nominated as the expert making the scheme report, provided the skilled person can demonstrate that the criteria set out in 6.1 and 6.2 are satisfied. The external auditors are responsible for also satisfying themselves that they could continue to act in their capacity as auditor if they were to be appointed as the skilled person. The PRA will consider each nomination on a case-by-case basis.

Appointment

6.5 The PRA may only nominate or approve an appointment after consultation with the FCA.

6.6 The suitability of a person to act as a skilled person depends on the nature of the scheme and the firms concerned.

6.7 Under FSMA², the application to the court may be made by the transferor, the transferee or both. When reasonably practical, the intended applicant should choose their nominee for skilled person, in the light of any criteria advised by the PRA. The intended applicant(s) should then advise the PRA of their choice, unless the PRA wishes them to defer nomination or to make its own nomination. The notification should be accompanied by reasons why the transferor or transferee considers the nominee to be a suitable person to act as skilled person. Other relevant details provided should include:

- (i) information about the nominee's experience and qualifications;
- (ii) the proposed terms and conditions of the nominee's appointment, including any remuneration arrangements;
- (iii) any current or previous professional or commercial arrangements with the transferor, transferee or their associated companies, including the remuneration (direct or indirect) for those arrangements with the nominee and/or with any professional firm or company in which the nominee has or has had any interest in the past five years;
- (iv) steps taken to assess any potential conflicts of interest arising from these relationships and, where conflicts of interest are identified, the measures taken to mitigate these. This should also be disclosed within the scheme report; and
- (v) any other matters that the PRA may consider necessary in order to form a view.

1 *PRA Supervisory Statement 7/14*, 'Reports by skilled persons', June 2014;
www.bankofengland.co.uk/pr/Pages/publications/ss/2015/ss714update.aspx

2 Section 107(2) FSMA

6.8 An overview of any arrangements whereby the skilled person sub-contracts work to third parties, as well as information of any planned review process (including the identity of the proposed peer reviewer), should also be submitted with the nomination. This should include the details outlined above where relevant.

6.9 The PRA may wish to have preliminary discussions with the nominee about the transfer before the PRA determines if they are suitably qualified to address issues arising from the transfer. These discussions may explore the scope of the work the nominee has previously undertaken and the existence of safeguards to mitigate any actual or perceived conflicts. The PRA, in consultation with the FCA, will consider the suitability of the nominee and will inform the firm that nominated them whether they have been approved. The firm should directly contract the skilled person. Since the nature of the scheme is a factor in determining the suitability of the nominee, the PRA cannot approve a nominee before the broad outlines of the scheme have been determined.

6.10 The PRA may itself nominate the skilled person (following consultation with the FCA), either where it indicates that a nomination is not required by the firm, or where it does not approve the firms' own nomination. In either case, the PRA will inform the applicant.

6.11 The PRA expects firms to cooperate fully with the skilled person and provide him or her with access to all relevant information and appropriate staff.

7 The PRA's certificate confirming consent of the RFTS application to the court

7.1 An RFTS application to the court may only be made with the consent of the PRA. In deciding whether to give consent, the PRA must have regard to the scheme report. The PRA will also consider all other relevant matters. These may include whether, after implementation of the scheme, the PRA-authorized firms within the group will be in compliance with threshold conditions and whether relevant entities in the group will be in compliance with the ring-fencing provisions.