



BANK OF ENGLAND

Speech

Putting up a fence

Speech given by

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Our [interactive guide](#) explains how ring-fencing makes the financial system safer and how it will affect the public.

Introduction

Work is underway - out of sight and behind the scenes - to build a large new part of the United Kingdom's vital infrastructure. Once complete, the programme will deliver significant improvements to the public. The next 18 months will be crucial for its construction, with little scope for slippage, or room for divergence from plans, in order to succeed by the 2019 deadline.

You might be forgiven for thinking that I am about to give a speech on the Crossrail engineering project about which much of the above is true. To be clear, I am not: improving journey times across London and easing congestion are not part of the PRA's objectives. Crossrail does, however, provide something of an analogy for the real subject of this speech – and something that certainly does form part of the PRA's objectives – building the ring-fence around the UK banking system.

Like Crossrail, ring-fencing is a major infrastructure programme that forms part of a broader strategy of co-ordinated improvements. Both programmes faced extensive periods of public consultation and detailed planning before building began. Both will largely be built behind the scenes, or underground, with certain visible exceptions like the new Crossrail station at Canary Wharf or the sort code changes that will result from ring-fencing.

Like Crossrail, ring-fencing is seeking to deliver wide-reaching benefits to the public. Ring-fencing aims to improve the resilience of the largest UK banks to enhance financial stability, to maintain the provision of core UK banking services used by individuals and small businesses, and to help protect taxpayers from any further bank bail-outs.

Both programmes face a high degree of delivery risk that all involved are seeking to monitor and mitigate. And, like Crossrail, ring-fencing is coming soon.

Why a fence is needed and who it is for

Let me begin with a reminder of why the ring-fence is needed, and for whom it is intended.

Ten years on from the start of the financial crisis, the United Kingdom is well advanced in implementing the wide-ranging international and domestic reforms aimed at fixing the causes of that crisis, and reducing the likelihood of another. New standards have been introduced to strengthen the resilience of the banking system, and to help solve the too-big-to-fail problem whereby it was too costly to allow banks to fail in the same way as any other company in the private sector could. These standards include the introduction of: the Basel framework for systemically important banks and the Systemic Risk Buffer, which sets higher capital requirements for those banks to increase their capacity to absorb stress; the regular concurrent stress-tests for the UK's largest banks and building societies to test their resilience; and the implementation of the EU's

Banking Recovery and Resolution Directive, including new requirements for UK banks and building societies to ensure sufficient funds are available to recapitalise any continuing parts of the business if the group, or part of it, were to fail. Overall, the largest banks are now required to hold very significantly more capital than before the crisis.

The implementation of the ring-fence is a key component of the post-crisis reforms in the United Kingdom. As the Governor recently said, “*efficient resilience is why we are ring-fencing the domestic banking services on which UK households and companies depend.*”¹ Building on the recommendations published by the Independent Commission on Banking (ICB)² in 2011, the requirements of the ring-fence were enacted by the Government through legislation³. Ring-fencing addresses the problem that arises from universal banks that allow investment and international banking activities to be placed on the same balance sheet as the critical functions of lending, deposit-taking and payment services for retail and small corporate customers. This increases the risks to the provision of those critical functions, and potentially puts tax payers on the hook to save the whole bank, if things go wrong in the investment bank or the global economy.

The 2013 Banking Reform Act requires UK banks to separate - or ring-fence - the provision of the core from other so called ‘excluded’ and ‘prohibited’ activities⁴ within the group by 1 January 2019 – the date on which the legislation takes effect. This separation supported by, for example, the introduction of a separate board for the ring-fenced bank that is able to make decisions independently of the rest of the group, will ensure that the business of the banks inside the fence is carried out in a way that protects, in both good times and bad, the provision of those core banking and payment services for UK retail customers and small businesses. And if the worst were to happen again, groups subject to ring-fencing will have group structures that are less inter-dependent and easier to resolve.

The legislation allows for proportionate application and recognises that not all banks are likely to conduct excluded activities. Building societies are not in the scope of the legislation, nor are banks with less than £25bn of core retail deposits. As it stands, only the five largest UK banking groups and some of their rapidly-expanding competitors will be in scope on 1 January 2019. These competitors in general face a smaller restructuring task, as their retail focus means they conduct few, if any, excluded activities. Nonetheless, separating activities in the large and complex banking groups is generating, arguably, the largest ever discrete change to the structure of the UK banking system, with banks accounting for approximately 75% of UK retail deposits being re-engineered over the next 18 months.

¹ Mark Carney, The high road to a responsible, open financial system, 7 April 2017

² Independent Commission on Banking: Final Report, 2011, Sir John Vickers

³ The Financial Services (Banking Reform) Act 2013

⁴ The Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014 sets out excluded activities (i.e. activities that must not be conducted by firms inside the ring-fence) as dealing in investments as principal and commodities trading. Firms inside the ring-fence are prohibited from accessing a payment system indirectly, incurring an exposure to a relevant financial institution (as defined in Part 3 of the Order), and holding non-EEA branches or subsidiaries. To ensure proportionate application, the Order also includes various exceptions and a transitional provision.

Designing the fence

Responsibility for implementing the Banking Reform Act – that is, successfully putting up the ring-fence on time - lies fairly and squarely with the banks themselves.

As for the PRA, the legislation has given us a specific objective to ensure that ring-fenced banks conduct business in a way that protects the provision of core banking and payment services in the UK, and insulates them from shocks that may arise in the rest of the group or from global or wholesale banking markets. This new objective is part of and fits within the PRA's overarching objective of safety and soundness. Detailed rules have been written to guide and support firms' ring-fencing plans – the PRA has consulted on and published three policy statements as required by, and as a supplement to the legislation, with rules covering, amongst other things, legal structures and governance arrangements; prudential requirements and intra-group arrangements; and reporting requirements. Work is also being undertaken by the FCA and other regulators to support those foundations, in line with their own statutory responsibilities.

Meanwhile, the PRA has been working with banks to understand their ring-fencing plans and their implications for our objectives. In line with the flexibility intended by the ICB, and built into the PRA's ring-fencing rules, each bank is adopting its own approach to meeting the legislative requirements - reflecting the differences in firms' strategies and expected future business models. Firms with predominantly UK-focused retail banking activities are opting to build a "wide" ring-fence that will house the bulk of activities, with only the relatively small rump of prohibited activities outside. Other firms with large international or investment banking activities have opted to build a "narrow" ring-fence, with the majority of corporate banking activities conducted outside the fence. Irrespective of the location of the ring-fence, the legislation is designed to allow ring-fenced banks to continue to reap the benefits of being part of a larger group, which would not have been possible if complete legal separation had been required.

Building the fence

The scale of the change required by 2019 means that the banks are already implementing their plans. For some, this includes seeking authorisation for the new legal entities that will enable them to house their banking activities either inside or outside the fence. By 2019, the PRA is expecting to have authorised the three largest new banks ever created in the United Kingdom. Change on this scale must be planned and delivered carefully, and so is expected to have cost the industry several billion pounds in total by 2019.

Separating the ring-fenced banks into distinct legal entities is not, however, sufficient to ensure ring-fenced banks conduct business in a way that protects core banking services: which is, after all, the intention of the legislation. Strong arrangements are necessary at board level to ensure that the ring-fenced banks can take decisions independently both in times of crisis and, in good times, to maintain the integrity of the ring-fence. Where conflicts of interest do arise, firms are expected to be able to identify and manage these.

The ability to act independently does not stop at board level, but - to be effective – needs to permeate throughout the organisation. Banks' IT systems, not always easy to change even at the best of times, need to be re-configured to enable the ring-fenced banks' financial ledgers to be distinct. And transactions and services (including HR, property, security etc.) across the ring-fence need to be negotiated on arms' length terms.

To be able to act independently also pre-supposes a certain level of financial independence. The viability of a ring-fenced bank needs to be sufficiently separated from that of the broader group. There would be no point in having the legal and governance separation if, in practice, the business models were so intertwined - or intragroup exposures so great⁵ - that one could not operate without the other. Firms' access to key payment and clearing systems is a prime example. Ring-fencing requires extensive engineering by some banks, together with the Bank of England and others, to re-work the essential plumbing of payment system connections and access. For similar reasons, ring-fenced banks will need their own capital and pools of liquid assets to be able to stand resiliently on their own.

The Bank of England will require full and prompt implementation of the ring-fencing legislation and requirements by 2019. To achieve this, much work must be completed by the banks within a limited timeframe. While the timelines vary, all banks plan to meet this tight deadline, with the bulk of restructuring activities planned from now to mid-2018. As with any big infrastructure project, there is some potential for disruption to everyday activities as new group structures are moved into place and new ways of operating are brought on-line. The banks' progress on implementing the ring-fence, and the risks arising from that work, will continue to be managed closely by the banks and monitored by the PRA and the FCA until all the requisite work is complete.

In short, there is a lot to be done.

What to look out for as the fence goes up

Much of the essential work should not be readily apparent to the wider public. To echo Sam Woods, *"Implementation will often pass the public by. That's OK – so long as households and businesses get a resilient and reliable service from the financial system."*⁶ But some elements of the building work will be visible. Customers of different banks may be affected in different ways. So what is there to look out for as the fence goes up? Today, I would like to mention two issues: changes to sort codes, and transfers of business⁷.

⁵ Including pensions. Under the legislation, pensions separation is subject to delayed implementation by 2026.

⁶ Sam Woods, The revolution is over. Long live the revolution!, 26 Oct 16, Mansion House, London

⁷ See Part VII of the Financial Services and Markets Act 2000

First, a sort code is the six digit number that has traditionally been attached to each of our bank accounts to identify the account not just with our bank, but also with a specific branch or product. As the ring-fence goes up, the banks will need to allocate each to one side of the fence or the other. And that means some customers could, in the absence of additional change, find themselves on the wrong side of the fence. To address this, the banks have put in place major programmes to re-allocate accounts to the right side of the fence. The banks estimate that almost a million retail and corporate customers will see changes to their sort codes. Banks will inform those customers that their sort code details are changing, when the change will take place and if there is anything they need to do. Some people may already have been contacted by their banks. To minimise the disruption these changes could cause to customers, banks will ensure that any outgoing payments, for example standing orders and Direct Debits, are made as normal. Banks and payment schemes will also redirect any incoming payments to the new account details. This critical work is being closely overseen by the FCA and PRA.

Second, the transfers of business. Some banks will need to move the assets and liabilities of significant numbers of customers from one legal entity into another to comply with the legislation. For example, a banking group that creates a new banking entity to house the ring-fenced activities will need to transfer into it the assets and liabilities of those customers it wishes to place inside the ring-fence. To do so, banks can use a transfer of business process called a ring-fencing transfer scheme⁸, where a judge will decide whether the transfer may proceed. In doing so, the Court will consider the impact of the scheme on customers and others, and whether that impact is reasonable for achieving compliance with the legislation⁹. The Court process is expected to begin in late 2017 and last into 2018. As part of that process, customers may receive communications from their banks explaining the proposed moves and the Court process that will facilitate them. The completion of these transfers will require co-ordination between banks, their customers and counterparties, the Courts, the PRA, the FCA and the independent experts reviewing the schemes on behalf of the Court.

Against the back-drop of other regulatory, accounting and business model changes – not the least of which is Brexit – it is easy to see that the banks in scope of ring-fencing are facing significant restructuring challenges. The steps the banks must take to implement the ring-fence by 2019 are interdependent, so delays in one area – should they occur – may knock-on to become bigger delays in other areas. The Bank of England is working with banks to ensure they have suitable contingency plans in place to meet ring-fencing requirements by 2019 even if delays do occur.

⁸ A ring-fenced transfer scheme (RFTS) is a modified form of Part VII transfer of business process available to firms that will be subject to ring-fencing from 2019 to use for the purposes of creating the separation of activities mandated by the ring-fencing legislation.

⁹ For each RFTS an independent expert will be engaged to write a report for the Court that seeks to assess the statutory question: "... whether persons other than the transferor concerned are likely to be adversely affected by the scheme, and 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". This report will form part of the evidence on which the Court will rely in determining whether it is appropriate for it to sanction the scheme. See section 109A of the Financial Services and Markets Act 2000.

The risks associated with introducing these changes, however, are outweighed by the long-run benefits of increasing banks' resilience and resolvability.

Once the fence is up

Completing the ring-fence on 1 January 2019 will be a major step towards implementing the package of post-crisis reforms, but the work will not stop there. Achieving the intended outcomes of ring-fencing will be a continuous, daily process – not a one-off event. For the banks themselves, this will require ensuring a clear line of sight of the ring-fence for both regulators and analysts to monitor, through regular reporting and disclosure obligations. As for the PRA, we are considering how to supervise banks with ring-fenced structures and whether this will require changes to our current supervisory approach and operating model. Not the least of our responsibilities will be the requirement to produce an annual report to Parliament publicly setting out the extent to which the banks have complied with the ring-fencing provisions¹⁰. Further to this, where we find a firm is not complying, we have new group restructuring¹¹, or “electrification” powers, which enable the PRA to initiate a number of changes to a banking group subject to ring-fencing, if certain conditions are met. This is an important structural foundation provided by the legislation to set the right incentives for banks to comply.

Conclusion

Constructing the ring-fence is a critical infrastructure project, remedying a major flaw in the previous financial architecture by insulating retail banking from risks arising outside the fence. This will contribute to a safer, more resilient and more resolvable banking system for the future – and like the successful opening of Crossrail, the completion of the ring-fence in 2019 will have been worthy of the building work taking place.

¹⁰ See paragraph 19 of Schedule 1ZB of the Financial Services and Markets Act 2000

¹¹ See sections 142K and 142L of the Financial Services and Markets Act 2000