Market Insight

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Ringfencing of banks:
A permanent cure or a sticking plaster?

London, 12 February 2013, by Mike Nawas and George Lamaris

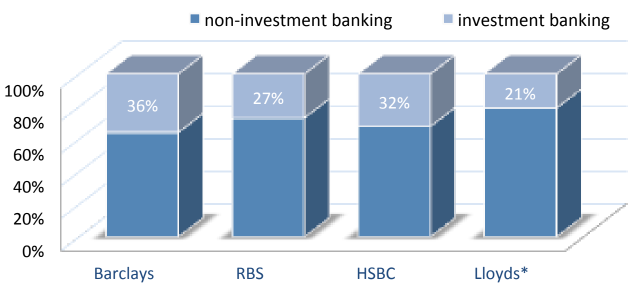
In the aftermath of the financial crisis regulators are moving ahead with the separation of the high street and investment operations of banks. Ringfencing of the retail operations of banks is an alternative to forcing complete de-mergers. Supporters of ringfencing argue that the financial system's stability will increase whilst banks will be able to retain some of the diversification benefits offered by the existence of retail and investment franchises under the same corporate umbrella. But is ringfencing a sustainable solution? This article examines the concept of ringfencing as pioneered in the UK, issues around its implementation and whether it is likely to achieve what it is designed for.

What is ringfencing?

Ringfencing is the creation of retail subsidiaries of large banks, which are operationally, economically and legally distinct from the rest of the organisation. Ringfenced retail banking operations that are considered to be too important to fail would be entitled to governmental support if needed. Conversely, the investment banking operations outside of the ringfence would not benefit from government support and therefore be allowed to fail.

For the large UK banks, investment banking currently contributes roughly one third of their income (Figure 1). The main concerns in the banking community, recently gaining momentum with politicians, relate to the costs and the potential threat that ringfencing poses for the City's position as a global financial centre with UK GDP forecast to shrink by £0.6-£1.4 billion per annum.[1] The current timetable is for ringfencing to be brought into law by 2015 and implemented in 2019.

Figure 1: Percentage of income attributed to investment and non-investment banking operations



Source: Annual Reports 2011 *total wholesale operations, no separate data available for investment arm

In the UK, the Independent Commission on Banking chaired by Sir John Vickers recommended ringfencing in their report of September 2011, arguing that ringfencing would offer benefits similar to complete separation but at a lower cost to banks and the economy as a whole (although the UK Chancellor estimates the costs to the UK banks to still be a considerable £4-7 billion a year). The main principles of the Commission's ringfencing proposals are set out in Figure 2.

Legal separation is the first and most critical step. *Operational* separation is aimed at ensur-

1 HM Treasury, "Banking reform: delivering stability and supporting a sustainable economy", June 2012

Figure 2: The basic principles of the ringfenced structure

Legal
- ringfenced banks offer only mandated and non-prohibited services
- any organisation (partly) owned by a ringfenced bank can only contract permitted services
- balance sheets can only contain assets or liabilities stemming from permitted services
- customer information is allowed to be shared over the fence

Economic
- all transactions should be on a commercial and arm's length basis
- assets should be sold within the group at their market values
- the ringfenced bank can only acquire assets resulting from permitted activities
- dividend payments are only permitted when capital requirements are fulfilled
- regular disclosure of intragroup transactions is required

Operational
- implement arrangements to have continuous access to operations, staff, data and services necessary for their activities irrespective of the condition of the rest of the group
- relevant infrastructure can be separately owned by the ringfenced entity, or supplied independently or provided by the group under service level agreements
- the ringfenced bank should be a direct member of all the payment systems

Governance
- the ringfenced entity's board should include a majority of independent non-executive directors
- the cross-over with the board of the rest of the group should be kept as low as possible
- dividends paid require regulatory approval if their payment causes concerns about the entity's viability

ing a smooth functioning of the ringfenced bank in case the rest of the group collapses: the ringfenced entity should be independent as far as its solvency, liquidity and operational continuity are concerned. The *governance* framework is likely to require regular disclosure of separate financial information on the ringfenced and non-ringfenced parts of the group. Moreover, consideration will have to be given to implications of the consolidation approach, e.g. as a subsidiary versus as an associated party, and consequences for reporting on related party transactions. *Economic* separation means, amongst other things, that assets can only be transferred through the ringfence at an arm's length price. However, importantly, the transfer of cash in excess of regulatory capital between the different entities is permitted, allowing for optimisation of capital allocation between the ringfenced and non-ringfenced activities.

Taking a principle-based approach, the Vickers Report suggests that banking activities be split into three types: *Mandated* (activities inside the ringfence, considered critical for the economy, which should not fail), *Permitted* (activities which, at the discretion of each bank, may be located on either side of the fence) and *Prohibited* (activities that must take place outside the ringfence). See Figure 3 for more detail. By introducing the concept of Permitted Services, the Commission has sought to create some flexibility to make the transition smoother and to avoid price bubbles for certain asset types due to artificial regulation-based pricing during the transition phase.

International perspectives

Since the publication of the Vickers Report, other countries have followed suit. In October 2012, a report on the restructuring of the European banking industry written by the European

Figure 3: Ringfencing structure

Mandated services (mandatory in the ringfence)	**Prohibited Services**
• taking deposits from individuals and SMEs • provision of overdrafts to individuals and SMEs **Permitted services** (allowed in the ringfence) • deposits from large companies and high net worth individuals • intermediation services (such as simple loans) to non-financial large companies • trade and project finance • mortgage lending and wholesale funding • investment products that do not require regulatory capital for holding them	• trading and investment banking activities (derivatives, underwritings, etc.) • services to financial companies • services to customers outside the EEA

Commission's High-level Expert Group on Bank Structural Reform that was headed by Erkki Liikanen, governor of the Finnish Central Bank, was released. Even though their recommendations are to a large extent in line with the Vickers Report, a crucial difference is that they allow for tolerance levels above which ringfencing should apply. For example, for banks with more than 15-25% of total assets held for trading or with trading activities that exceed €100 billion, legal and operational separation will be enforced. The Liikanen approach implies ongoing monitoring of the level of proprietary activities to determine the need for ringfencing and it is at regulators' discretion to extend the ringfence for systematically important banks.

The Volcker Rule in the Dodd-Frank legislation in the US goes even a step further by completely banning proprietary trading activity of banks. The combination of all these requirements is that global banks with UK, European and US operations may need to construct different ringfences and pursue varying business models in varying jurisdictions. This inevitably increases operational costs of the banks, and the consequent reduction in profitability will normally be compensated by banks charging higher margins to their customers or by investing in riskier activities to maintain the same level of profitability. It should also be considered whether the variety of international ringfencing requirements creates an unlevel playing field for global banks, depending on their business mix or their country of origin.

Loosening or electrifying the ringfence

Given the above, it is no surprise that as a result of consultation with the banking industry the reform process seems to be relaxing its initial stance. The June 2012 White Paper, the UK government's response to the Vickers Report, has loosened the leverage ratio requirement. Also, the minimum capital threshold for banks with a significant international operation was removed, allegedly after threats from HSBC and Standard Chartered to move their headquarters out of the UK. Furthermore, the sale of some derivative products is now permitted within the ringfence and one must bear in mind that it is difficult to determine whether a derivative is being used for hedging or for speculative purposes. This trend to loosening of the ringfence has been picked up by politicians from all parties in the UK parliament. They are concerned that the tax-payer may still be bearing too much bail-out risk even after ringfencing because banks are left with too much room for gaming of the system by virtue of their discretion as to which activities to include and exclude of the ringfence. Their counter-response, now accepted and adopted by the UK Chancellor George Osborne has been to call for "electrifying" the ringfence: allow the regulatory authorities to switch the ringfence into a permanent separation if they detect misuse of discretion by banks in interpreting the ringfencing rules. Clearly, the last has not been said about the details of implementing ringfencing.

Unintended effects
Ringfencing also leads to unintended effects that may undermine its effectiveness. The part of the bank that falls outside of the ringfence will have to deal with higher costs of debt and equity. Therefore, it may be forced towards riskier and trading-oriented activities. The investment banking arms could evolve into hedge funds with aggressive investment strategies, higher earnings volatility and a business model that is transactional rather than relationship-driven. Their businesses would actually become *more* likely to require bail out. And because these entities could be very large and systemic and therefore, by their very nature, still "too big to fail", governments may decide to bail them out if needed even though they reside outside of the ringfence.

Also, for banking groups with ringfenced and non-ringfenced activities, potential failure on either side of the ringfence could cause reputational damage to the whole organisation and still precipitate failure of the healthy part via contagion – depositors flocking away from a tainted brand.

Clearly such outcomes would put into question the entire effectiveness of the proposed regulation. Other unintended effects could emanate from the bifurcation of credit ratings that will be caused by ringfencing. Currently, the credit rating agencies typically provide two types of ratings for banks, one that assumes that sovereign support is available (the "all-in rating") and one that excludes the sovereign support (the "stand-alone" rating). Due to ringfencing, higher all-in based credit ratings will be assigned to the ringfenced parts of banks whilst the credit ratings of non-ringfenced activities will migrate towards the lower credit ratings that are assigned on a stand-alone basis. Consequently, funding costs and funding access will begin to considerably vary between the ringfenced and non-ringfenced parts of banking groups. HSBC, in a report published in June 2012, estimated that eliminating assumed governmental support from bank credit ratings would cause a drop of two to five notches for the part of the bank that is not included in the ringfence[2]. Fitch, however, believes it is pre-mature to try to determine the rating gap between the ringfenced part and the rest of the group, since the effect of the lack of sovereign support will be partly mitigated by higher capital requirements.[3]

Is break-up a more viable option?
As a consequence of the dilutive measures now announced and the above-mentioned potential unintended effects, at Bishopsfield Capital Partners we believe that ringfencing as a solution to enhance the overall stability of the financial system and to make retail banking immune to shocks from investment banking activities may have been over-sold to the public. Moreover, the ringfencing rules will increase the complexity of governance of banks making them harder to manage, oversee and regulate in the long-term. Even more so for global banks that will have to comply with diverse ringfencing rules in the geographies in which they operate. Electrification of the ringfence may give the regulations more teeth, but it will not overcome ringfencing's unintended effects and complexities. This begs the question whether ringfencing will only prove to be an intermediary step to a full break-up of banks with high street and investment banking divisions, perhaps triggered after some of the unintended effects materialise and once again shock public confidence in the banking system and regulations.

But perhaps we will not have to wait for such a shock to the system. The sheer complications and ongoing costs of governance and operations required to implement, monitor and manage diversified banking groups with both types of activities could outweigh any perceived synergies of keeping banking groups intact. Market forces could drive banks to break up rather than sustain complex and expensive ringfences: acquirers with no ringfences (e.g. pure investment banks, or pure retail/corporate banks) may be able to argue that the break up value of a target banking

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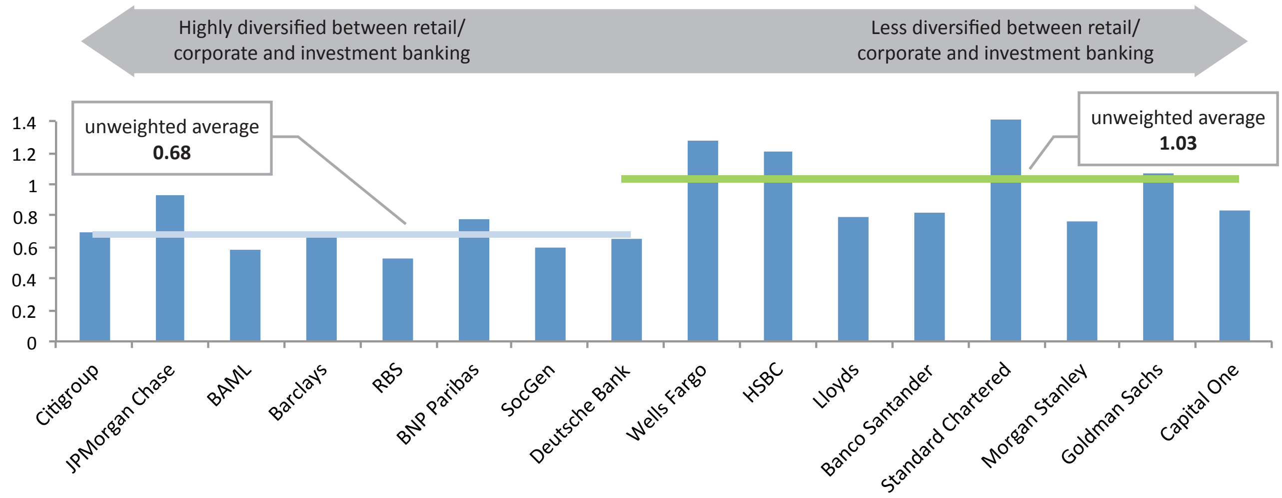
2 HSBC Global Research, "The ICB ringfence: this is going to hurt…", 22 June 2012

3 Fitch, "Ringfencing could widen ratings gap within bank groups", 10 October 2012

Figure 4: Comparison of Price to Book ratios of different banks (as of February 4th, 2013)



Source: Bloomberg

*calculated as the ratio of the market capitalisation as of Feb 4th, 2013 to book value as of most recently reported quarter

group is larger than its going concern value. Such a proposition may resonate with shareholders in diversified banking groups, who could become disgruntled with the low returns on their investments in diversified banking shares.

This concern with the going concern market value of diversified banking groups may well already be reflected in current valuations. Figure 4 provides an interesting illustration (we stress that we cannot call it more than an illustration, as there are many more factors that come into play in valuing banking groups).

It is clear that valuations across the sector remain depressed (below or just above 1.0x Price/Book). By and large, it also appears that banking groups that are highly diversified across retail and corporate banking on the one hand and investment banking on the other hand are suffering the most. Institutions that represent core business models of either retail/corporate banking or investment banking fare better, albeit not by much. At least: not yet – based on the considerations above, that may still come.

The general public and – as a logical consequence – policy-makers too, have a heightened sensitivity to weaknesses in banking regulation. Policy-makers are therefore likely to pick up on such weaknesses and develop new, tighter regulations. Consequently, ringfencing is likely to continue to evolve and will probably look rather different by the time it is implemented than when it was first conceived.

If you agree with our views in this Market Insight, and even if you don't, we would be delighted to hear from you (info@bishopsfieldcapital.com).