Ring-fencing and its implications for clients

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A range of new regulatory initiatives were created in response to the global financial crisis, many with the aim of improving the resilience and resolvability of banks. Oliver Knight, Managing Director of Regulatory Solutions and Akhil D. Shah, Director, Bank Propositions and Network Management at Lloyds Bank, examine the impact on UK banks, as well as their clients, with a focus on transaction banking implications.

What is ring-fencing?

Ring-fencing in the UK is, alongside Recovery and Resolution Planning (RRP), one of the key building blocks of the UK Government's legislative agenda for Bank Structural Reform. A key recommendation from the Vickers Report in 2011, ring-fencing mandates the separation of Retail and SME[1] deposits from activities, perceived as being more risky, including complex hedging and market making.

In general, simpler, low risk activities are to be offered from within a ring-fenced bank (RFB) whilst more complex activities are to be housed into a separate entity, commonly referred to as a non-ring-fenced bank (NRFB). The aim is to protect critical banking services for Retail and SME clients from the perceived risks associated with more complex trading activities needed by larger organisations.

In the UK, the legislation currently only impacts the larger banks, those with large enough customer deposit bases. The threshold for banks coming into scope for ring-fencing is determined by the size of the Retail/SME deposit base. Any bank with more than £25bn of core UK Retail/SME deposits will be required to be ring-fenced by 1 January 2019, meaning that the larger UK banks are all in-scope. Smaller traditional and challenger banks with less than £25bn Retail/SME deposits in the UK are exempt, although they can choose to opt in and several are very close to the £25bn Retail deposit threshold and may therefore come into scope in the future.

Ring-fencing legislation is founded on two key concepts: 'Perimeter' and 'Height'.

- 'Perimeter' rules govern activities permitted inside a ring-fenced bank (see diagram overleaf.)
- 'Height' determines the degree of separation of the ring-fenced bank from other activities in a broader banking group.

The aim is to reduce the probability and impact of bank failure, and to reduce systemic risk contagion in the financial services sector.

Legislative compliance is due by 1 January 2019, with a grand-fathering period for certain exposures maturing prior to 2021. The expectation is that each of the larger banks will maintain both RFBs and NRFBs within their UK banking groups.

How will the banks react and what will change from the clients' perspective?

The legislation will result in a range of structural changes, some significant, for each of the in-scope UK banking groups. For each, their challenge will be implementing the measures in a way which minimises the impact on their client proposition.

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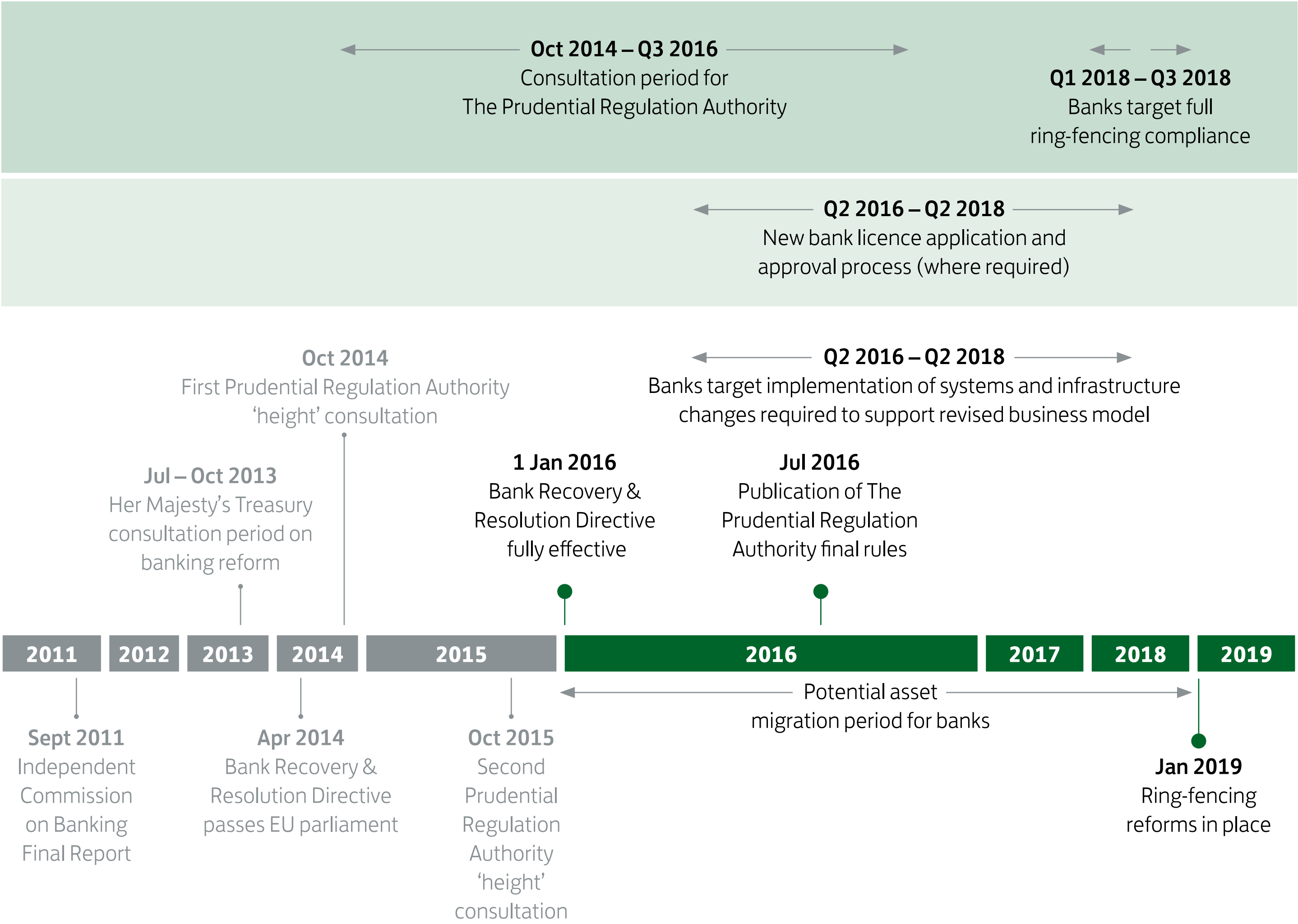
A generic indicative timeline of ring-fencing activities across the industry



For Retail and SME clients, the impacts will depend upon their bank. Some UK banks will need to implement large-scale changes of account numbers and sort-codes depending on whether their clients need to be migrated to a new entity.

The experience for corporate and institutional clients will also vary according to the response of their bank. Several of the larger banks, for example, are expected to move their full corporate proposition into non-ring-fenced banks. Others are likely to book the corporate and institutional business which is permitted inside the ring-fence into their larger RFBs – only activities prohibited inside the ring-fence must be moved.

For those financial institution clients classified as relevant financial institutions (RFIs)[2], RFBs are, with some exemptions, prohibited from being exposed to these clients in order to prevent systemic risk contagion in the event that a RFI fails. However, amongst the exemptions are provisions for credit exposures resulting from a ring-fenced bank facilitating cash management, payments and transactions involving goods and services.

Lloyds Banking Group intends to serve the vast majority of commercial clients from inside the ring-fenced bank. This is a logical decision, given the majority of the Group's banking assets are eligible to sit inside the ring-fence. The strength of Lloyds Bank's balance sheet, the scale of the Retail business, and the credit rating are likely to create one of the largest ring-fenced banks in the market. The Group also plans to be able to offer its core transaction banking products (including cash management and payments) to clients from within the ring-fence. Global Transaction Banking (GTB) clients will largely experience continuity in terms of their proposition, and avoid major transition challenges.

Lloyds Banking Group plans to offer products no longer permitted in the existing booking entities from 2019, from its NRFB. This should enable the Group to continue serving more complex corporate and institutional client needs. The propositions which are expected to be booked outside the ring-fence include certain risk management products, debt issuance and financing for certain types of financial institutions, classified as RFIs.

Lloyds Banking Group plans to serve all clients via a single relationship manager, guiding queries and presenting our offering from a single point of contact. The Group plans to offer an integrated proposition, with a shared relationship management, sales and servicing layer which straddles the multiple booking entities within the Group. In many ways, this is a continuation of the Group's existing model – the relationship management teams already offer propositions from multiple balance sheets within the Group (in the UK and abroad). The client experience should also stay very similar. The international proposition, focused in Europe, US and Asia, is intended to continue to be aligned with the broader model, per these plans.

What are the key issues, and areas of complexity, to consider?

There are a number of questions that financial institutions and their clients may wish to ask themselves when considering the implications of ring-fencing.

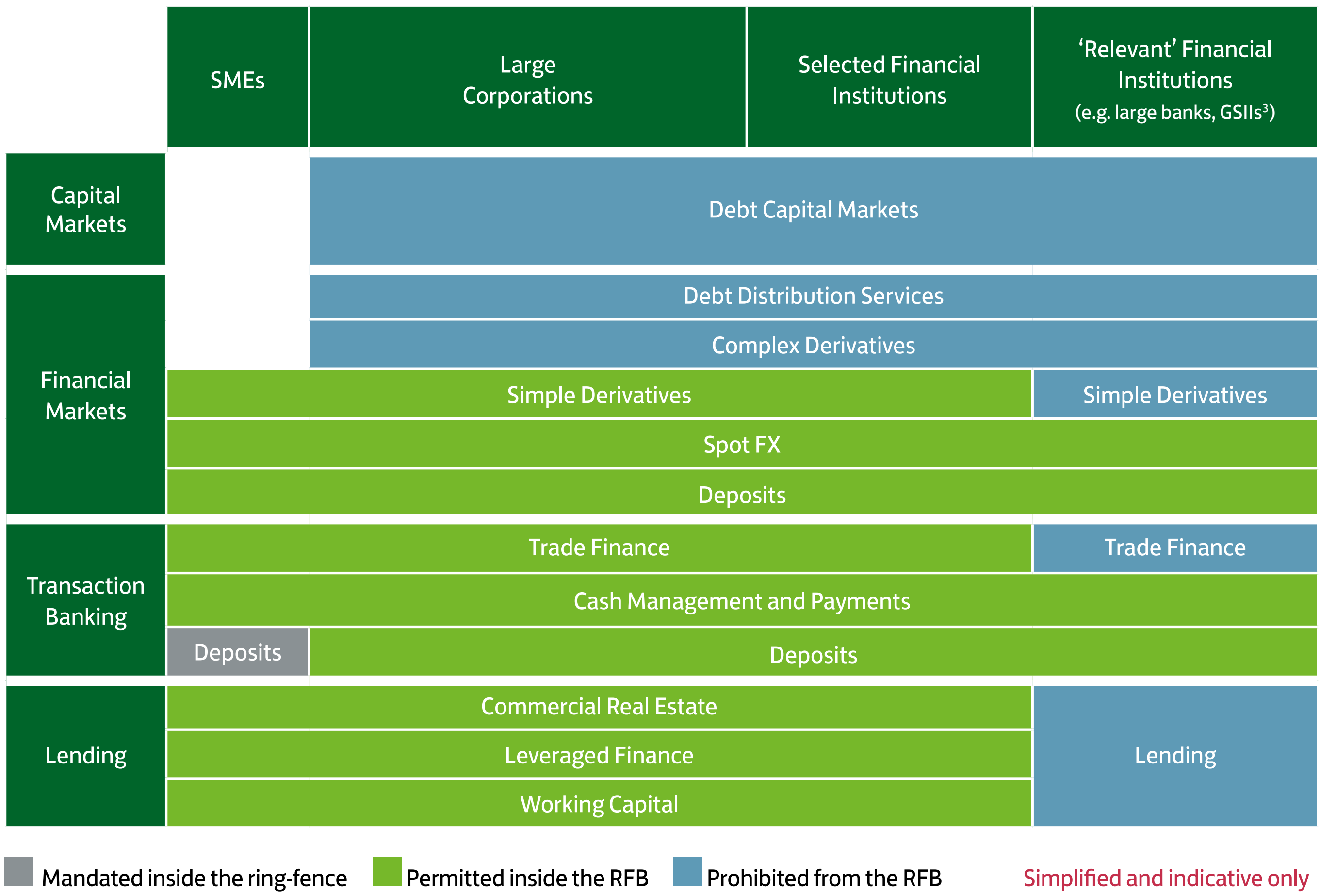
1. What are the implications for booking models and asset allocation across the ring-fence?

The challenge for corporate and institutional clients, including correspondent banks, will be how to manage their interactions across the ring-fence within UK banking groups. Clients and their banks will need to consider how best to optimise their booking and allocation of assets on each side of the ring-fence. They should review the potential synergies between different activities, consider the credit rating, funding (and broader strength of the entity), and other possible differences between RFB and NRFB balance sheets.

2. What does this mean for the provision of transaction banking and liquidity management?

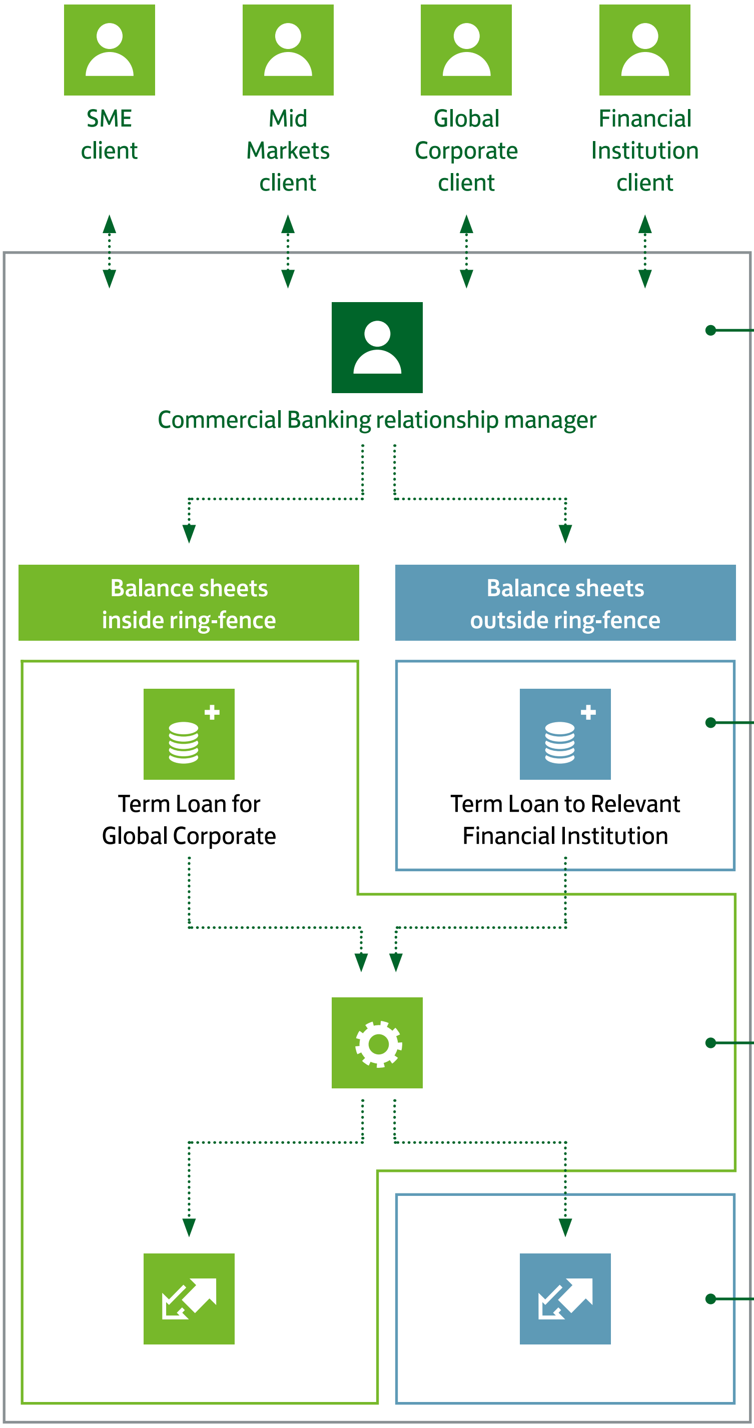
Ring-fencing and Recovery and Resolution Planning mean that the market landscape for UK transaction banking may look quite different in three years' time. The first significant change is that each banking group

Although the ring-fencing perimeter applicable to Lloyds Banking Group is still to be finalised, a generic and simplified view of the corporate banking products is set out below:



Indicative deal flow after implementation of the ring-fence – Lloyds Banking Group example

Lloyds Banking Group is planning, subject to regulatory approvals, to maintain a single point of contact for all Commercial Banking clients, which will offer propositions from both balance sheets inside and outside the ring-fence. An indicative diagram of a typical deal life-cycle is below:



1

Clients engage Commercial Banking relationship manager

All clients continue to deal with their existing relationship manager, who offers solutions based on Lloyds Banking Group product suite.

2

Relationship manager offers product from appropriate Lloyds Banking Group balance sheet

Depending on the client and the nature of their request, the product will either be offered from the RFB or one of the Group's balance sheets outside the ring-fence.

The Group will always be transparent with clients about which entity in the Group they are dealing with.

3

Existing teams and points of contact continue to support clients

Lloyds Banking Group existing operational and service teams will continue to service clients across all banking products offered by the Group.

4

Product is booked, and funded, from appropriate balance sheet

Client facilities are offered from, and booked to either RFB or NRFB balance sheets.

may seek direct membership to the primary UK payments schemes (including CHAPS – the Bank of England's real-time gross settlement payment scheme) for both their RFB and NRFB entities.

In theory therefore, the banks could provide a transaction banking offering from either their RFB or NRFBs.

3. What are the implications for Agency Banking?

The inter-play of ring-fencing legislation, RRP (including requirements for operational continuity), and UK payment scheme membership rules may have profound effects on Sterling agency banking. RFBs must, in effect, all have direct membership of CHAPS. CHAPS tiering rules, in turn, broadly dictate that any bank with more than 2% of total CHAPS daily payment transaction value or volume, or more than 40% of the agency member's average daily value or volume must, in turn, become direct members.

As a result, each RFB and NRFB may have direct membership of UK payment schemes. As banks work through the legislation it will become clearer which entity each banking group will offer agency banking services from. As a result, for some clients of UK banks a sort code/account number change may be required.

This may create additional complexity for clients who rely on these banks for agency scheme access to the UK payment networks. Lloyds Banking Group, by virtue of the existing proportions of its Group, plans to keep its existing payment scheme memberships inside the ring-fence, and, as today, will continue to offer agency access to existing clients with minimal impacts anticipated and with no new sort code/account numbers required.

4. What are the implications for Correspondent Banking?

A logical extension is the impact on correspondent banking – each RFB and NRFB is also likely to require their own Nostro and Vostro accounts for international payments. Correspondent banks attracted to the high inflows and outflows associated with large-scale Retail banking businesses will want to maintain relationships with the ring-fenced side of the banking groups. However, relationships with the NRFBs will also be required to provide access to corporate/institutional clients.

Management of liquidity across Nostro and Vostro accounts across the UK banking industry is likely to become more complicated, with more sophisticated sweeping and pooling arrangements being required. Furthermore, driven by regulatory requirements around intraday liquidity monitoring, banks will need to monitor their balances in real-time so that they can react quickly to market developments. Traditionally, banks have relied on overnight statements from their foreign bank providers for their accounting and, although intraday tools are available, integrating that kind of information into bank systems is not always easy. This will require working with the Nostro Agent banks to enable reporting and management information. Lloyds Banking Group plans to adopt these changes seamlessly without impacting the customer proposition.

5. What are the implications for Trade Finance?

A large part of Trade Finance involves taking risk on RFIs, for example via Export Letters of Credit and Inward Guarantees. Where these transactions relate to an underlying flow of goods or services, and when booking within the European Economic Area, banks are able to apply exemptions meaning these products can sit within the ring-fence.

6. What will be the transitional impacts?

The key point to note here is the transitional impact. Where a bank's business model involves significant carve-outs of client relationships into new entities, it will, from a transaction banking perspective, need to make extensive current account and sort code changes. The knock-on impact for clients (on each side of the ring-fence) in terms of disruption caused by sort-code separation may be significant.

Lloyds Banking Group's intended model is very simple. Lloyds Banking Group does not plan to move any existing accounts or sort codes outside of the ring-fence, minimising the impact for clients. This creates a real opportunity for Lloyds Banking Group to work with clients and improve the offering.

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Supporting the core payment needs of our clients – both domestic and international – is the foundation of our client offering, and integrated with our wider product proposition. By responding to both the wider regulatory environment and the continued transformation of our industry through technology, we will continue to invest in critical infrastructure to build our digital capability in Global Transaction Banking (GTB). Looking forward, this should provide the Group with a strong opportunity to innovate in its GTB offering, whilst other banks are completing the kind of implementation which the Group went through as part of its carve-out of the TSB business.

This investment is part of a £1bn group-wide investment in digital (a third higher than previously planned) that was announced as part of our strategic update in October 2014. One outcome of this investment is that we are now rolling out a new digital transaction banking channel with clients.

Our existing relationship managers and product experts will continue to support our clients and ensure a smooth onboarding onto our non-ring-fenced balance sheets to support their product needs beyond cash management and liquidity.

Conclusions

Ring-fencing regulation is still in consultation and may be subject to further change, and accordingly the plans of UK banks may also change.

For many clients, there will be a need for meaningful and ongoing engagement with ring-fencing as the UK banks and their clients are on a long journey to the final implementation deadline in 2019.

In particular, substantial questions regarding the 'height' of the ring-fence remain outstanding. Nonetheless, the banks in-scope for ring-fencing are pushing ahead to confirm the implications for their client propositions, and are likely to start engaging externally with clients over the next 12 months.

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Lloyds Banking Group remains committed to ongoing dialogue with clients to work through the implications and opportunities, as the rules get clarified and propositions get defined. The Group also remains committed to minimising impact to our clients and to look for opportunities to innovate as we move towards 2019.

Notes:

[1] SME definition used is per the UK Companies Act 2006 small company definition. A small company must meet at least two of the following criteria: (i) turnover: not more than £6.5m; (ii) balance sheet total: not more than £3.26m; and (iii) number of employees: not more than 50.

[2] RFIs – other Banks, Investment Firms, Structured Finance Vehicles, Globally Systemically Important Insurers, UCITS, Management Companies and Financial (pure or mixed) holding companies.

[3] Globally Systemically Important Insurers.

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