BRIEFING

THE VICKERS REPORT ON UK BANK REGULATION – BIG CHANGES ON THE HORIZON

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INTRODUCTION

The Vickers Report on the UK banking sector recommends radical reform of the operations of Britain's biggest banks, but has allowed eight years for implementation.

The reforms are projected to cost between £4bn and £7bn, and could leave up to £2tn of assets behind a regulatory ring-fence, protecting them in the event of catastrophic losses in other areas of an integrated bank's business.

BACKGROUND

In the wake of the global financial crisis, the most prominent symptoms of which were the collapse of Lehman Brothers and emergency government intervention into Northern Rock, RBS and other financial institutions, the UK Government appointed an independent commission, headed by Sir John Vickers, to make recommendations aimed at improving the stability and competitiveness of the banking sector in the long term.

The aims of the Commission, as set out in its Interim Report, were to produce a package of measures which would:

1. Make banks better able to absorb losses;
2. Make it easier and less costly to sort out banks that still get into trouble; and
3. Curb incentives for excessive risk-taking.

RECOMMENDATIONS

The Commission's final report was published on 12 September 2011 ("the Report"). Three key recommendations were made:

1. Integrated banks to ring-fence their retail banking businesses from investment banking activities;
2. Large UK retail banks to maintain equity capital of at least 10% of risk-weighted assets (a substantial increase on the current position); and
3. Retail consumer switching to be made much easier than at present, possibly by way of introducing universal account numbers.

Ring-fencing of retail banking

The most widely publicised of the Report's recommendations is the proposal to divide retail banking from wholesale/investment banking operations. The Commission stopped short of ordering total separation, but the solution which it settled on – ring-fencing – nevertheless marks a significant departure from the current way in which integrated banks do business. Under the proposals, UK retail banking activities would be carried out in separate subsidiaries of larger banks. These would be legally, economically and operationally independent from their parent groups, and would have distinct boards of directors and corporate governance arrangements.

Banking for individual customers and SMEs will be within the ring-fence. Banks will be permitted to choose whether lending to large companies (other than financial institutions) takes place within or outside the ring-fence. The ring-fenced portion of an institution will not however be permitted to engage in any of the following activities:

1. Provision of services to non-EEA customers;
2. Provision of services resulting in exposure to other financial institutions;
3. 'Trading book' activities;
4. Services relating to secondary markets activity; and
5. Derivatives trading.

Capital adequacy requirements

The recent financial crisis demonstrated that many retail banks lacked sufficient capital and reserves to absorb heavy or systemic losses. The Basel III agreement, to which the UK is a signatory, will require deposit-taking banks to hold equity capital of at least 7% of total risk-weighted assets by 2019. The Commission went further than this, specifying that by 2019 deposit-taking banks should have:

1. Primary loss-absorbing capacity (equity plus long-term debt required to bear losses before redemption) of at least **17%** – **20%**;
2. Equity capital of at least **10%** of risk-weighted assets; and
3. A system of depositor preference, by which customer deposits would always rank higher than other unsecured debt in the event of insolvency.

The combined effect of the ring-fencing and enhanced capital adequacy requirements will inevitably be an increase in the cost of the provision of retail banking services. The Commission has expressed its hope (but no more) that this will not result in higher charges to personal and business customers.

Competition

The Commission had been expected by some observers to recommend that the current UK retail banking market (and particularly the Lloyds – HBOS merger) be referred to the Competition Commission. This was a result at least in part of the fact that 77% of personal current accounts and 85% of SME current accounts are held with the four major banking groups. Referral to the

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Completion Commission was not recommended in the immediate future, but the Report did suggest that the Government seek agreement with Lloyds to ensure that its planned divestiture of 632 branches leads to the creation of a strong challenger bank to the existing big four.

The Report also proposes that the new Financial Conduct Authority be tasked with a clear primary duty to promote effective competition. In order to increase meaningful competition in the retail banking sector, the Government has been urged to consider a number of options, including the introduction of portable universal account numbers, which would go with a transferring customer from one bank to the next, greatly improving the ease of switching between provider banks.

LEGAL PERSPECTIVE

The proposed changes are radical, but a long period has been granted for their implementation. Large banks will have little alternative but to comply; for institutions that are less enthusiastic, enforcement will be by a mixture of primary legislation and regulatory controls.

Reacting to the Report's publication, George Osborne stated that primary legislation would be passed before 2015, but that banks would be given time to implement the most significant changes.

The application of the Report's recommendations is limited to banks carrying on business within the United Kingdom. It remains to be seen whether other economies will follow Britain in imposing the most stringent controls on retail banking seen for a generation.

Smaller financial institutions and other deposit-taking entities conducting business in the UK are not presently affected to the same degree as large banks, but are certain to experience an increased regulatory burden as the Report's recommendations are incorporated into statute and related codes of practice. Watch this space...

For information on the Bank Governance and Compliance Advisory Services at Stephen Platt & Associates LLP contact Stephen Platt or Frank De Mita.