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March 19, 2013

UK Regulators to be Given Power to Break Up UK Banks

The U.K. Government recently published the Financial Services (Banking) Reform Bill (the "**Bill**") which implements the key recommendations of the U.K.'s Independent Commission on Banking (the "**ICB**"). The ICB was established in 2010 to make recommendations on:

- structural measures to reform the U.K. banking system and promote stability and competition. This included the complex issue of separating retail and investment banking functions; and
- related non-structural measures to promote stability and competition in banking for the benefit of consumers and businesses.

In particular, the Bill includes the ICB's proposal for "ring-fencing" the retail and investment businesses of banks.

The U.K. Treasury also announced in its Banking Reform: a new structure for stability and growth paper that the Government will amend the Bill to give regulators the power to break up banks which do not comply with the ring-fencing rules so as to ensure the independence of any ring-fenced bank. This goes further than the original ring-fencing proposals and has come to be known as "electrifying the ring-fence." The Government, however, declined to go as far as giving regulators the reserve power to require sector-wide separation as recommended by the U.K. Parliamentary Commission on Banking Standard (the "**PCBS**").

Much of the detail of the ring-fencing proposals will be set out in secondary legislation so that the regime can adapt to innovation in financial services and markets. The Government intends that legislation implementing the ICB recommendations be in place by mid-2015 and in force by 2019.

On 8 March 2013, ahead of the Bill's second reading, the Treasury published draft versions of the following secondary legislation:

- Ring-Fenced Bodies and Core Activities Order
- Excluded Activities and Prohibitions Order
- Fees and Prescribed International Organisations Regulations

The Government intends to formally consult on draft secondary legislation to be made under the Bill later this year.

Although the proposals are unlikely to come into effect any time soon, banks will be considering how retail operations can be ring-fenced from investment banking activities. When these operations are divided, retail banking units must learn to become entirely independent from the investment operations of their parent bank, forcing business model changes. Businesses with U.K. operations which use U.K. banking services will need to assess how the proposed changes will affect retail banking costs and credit availability.

The Proposals (and Uncertainties)

The proposals aim to address the "too big to fail" issue and protect high-street banking activities from riskier investment activities. Under the Bill, deposit-taking activities will be ring-fenced from a U.K. bank's investment business.

The ring-fencing rules will apply to a U.K. deposit-taker (excluding building societies) (a "**ring-fenced bank**"). However, the Treasury will be given the power to specify in secondary legislation other core activities that could fall within or outside the ring-fence. The Government proposes to prohibit a ring-fenced bank from entering into any transaction which gives rise to a financial institution exposure except in the following limited circumstances:

- the sole or main reason for entering into the transaction is to hedge interest, exchange rate or default risk;
- the transaction is a commercial transaction, conducted on arm's length terms, with a group member and is not prohibited by the rules of the U.K.'s new regulators — the Prudential Regulation Authority (the "**PRA**") and the Financial Conduct Authority (the "**FCA**");
- the exposure is to a "small credit institution" and the transaction does not increase the ring-fenced body's aggregate exposure to small credit institutions above certain thresholds;
- the exposure is a payments exposure, and the transaction does not increase the ring-fenced body's aggregate payments exposure above certain thresholds;
- the exposure is a settlements exposure, and the transaction does not increase the ring-fenced body's aggregate settlement exposure above certain thresholds; and
- the transaction's purpose is the issuing or confirming of a letter of credit (issued in connection with the supply of goods or services, specifying the total credit available and subject to uniform customs and practice) for a non-financial institution customer, provided that the total exposure of the ring-fenced body in relation to letters of credit does not exceed a certain threshold.

The thresholds referred to above and the "small credit institution" definition are yet to be determined.

A ring-fenced bank will not be allowed to deal in investments as principal, except in limited circumstances relating to the management of its own risks, liquid assets buffer or the provision of derivatives to its customers for limited purposes. On the latter point, the Government is assessing whether ring-fenced banks may sell simple derivatives to customers. The PCBS has suggested that the sale of such products by a ring-fenced bank could undermine the ring-fence. It has, therefore, proposed that "simple derivatives" must be defined in legislation and that their sale should be subject to strict controls designed to prevent mis-selling. The issue of a proprietary trading ban will be considered in further detail by the Government and the PCBS. However the Treasury noted that there are significant difficulties in separating proprietary trading from market-making and the technical difficulties encountered by U.S. regulators in implementing the Dodd-Frank Act's Volcker Rule.

The Government also proposes to prohibit a ring-fenced body from using clearing, settlement or any other services provided by a recognised inter-bank payment system except as a direct participant through membership, or as an indirect participant through a contractual relationship with another ring-fenced body which is itself a system member.

The ICB recommended banning ring-fenced banks from providing services to non-European Economic Area ("**EEA**") customers. The Government decided to take a modified approach and instead

will prevent a ring-fenced bank from operating a non-EEA subsidiary or branch without the approval of the PRA, where this would present risks to the resolution of the institution. The PRA will only be able to approve an application to operate a non-EEA branch where it is satisfied that:

- there are sufficient information sharing arrangements in place between the PRA and the relevant overseas regulator;
- a Bank of England or Treasury stabilisation measure would be enforceable under the law of the relevant country/territory; and
- approval would not increase the risk of the ring-fenced body's failure having an adverse effect on the continuity of the provision within the U.K. of core services.

Banking groups will not be required to carry out all retail and SME (defined below) lending from within the ring-fence, but, given the economic importance of credit to individuals and SMEs, lending from the non-ring-fenced part of the business will be closely monitored by the Government.

What Are the Exemptions From Ring-Fencing?

Deposits from certified high net worth private banking customers and larger organisations will be allowed (but not required) to be deposited outside the ring-fence. A certified high net worth customer is an individual who, within the last 18 months has provided a statement of high net worth to the effect that s/he held "free and investable assets" to the value of £250,000 or more. Deposits made by an enterprise deemed to be a SME which is not a financial institution is caught by the ring-fence. A SME for these purposes is (i) an enterprise which employs fewer than 50 staff and has a turnover of not more than £6.5 million or an annual balance sheet total of not more than £3.26 million, or (ii) a charity, charitable incorporated organisation or other voluntary organisation which has a gross income of not more than £6.5 million. A financial institution for these purposes includes credit institutions, investment firms (unless they are authorised to deal as principal or agent), securitisation companies, insurance undertakings, funds, etc., but does not include ring-fenced bodies, building societies or credit institutions.

A de minimis exemption from ring-fencing for smaller deposit-taking institutions will be introduced. Broadly, a U.K. institution will be exempt if it holds total core deposits of £25 billion or less (calculated by reference to all U.K. deposit taking institutions in the group, where relevant).

Although the Government is continuing to assess how it will implement the exemptions from the Primary Loss-Absorbing Capacity requirement for overseas assets, it accepts the PCBS's proposal of placing the burden of proof on the bank seeking to use this exemption.

The Ring-Fencing Rules

A ring-fenced bank needs to be "legally, economically and operationally" separate from the nonring-fenced part of the corporate group with which it is affiliated. The ring-fencing rules made by regulators must therefore include provisions which:

- restrict a ring-fenced bank from entering into contracts with other group members other than on an arm's length basis';
- restrict any payments (including dividends) a ring-fenced bank may make to group member;
- require transactions between a ring-fenced bank and group members to be disclosed to the regulator;

- require the directors of a ring-fenced bank to be independent from other group members and be personally responsible to ensure compliance with the ring-fencing rules;
- require compliance with remuneration and human resources policies; and
- require the establishment of arrangements to identify, monitor and manage risks.

The Treasury stressed that the ring-fence rules and secondary legislation should not be seen by the banks "merely as a basis for negotiation" with the regulator. To ensure that this does not happen, the regulator will be given the additional objective to protect the continuity of core services and the power to make any rules it "considers to be necessary or expedient" to achieve the degree of separation envisaged by the ICB.

Additionally, U.K. banks will need to separate their pension liabilities so that the ring-fenced bank will not be liable for the pension liabilities of the wider corporate group.

Deposits protected by the Financial Services Compensation Scheme will be given preference over other creditors of a ring-fenced bank.