



The UK Independent Commission on Banking report

Flexibility forces fundamental change

September 2011

Executive summary: the UK ICB report

The recommendations, challenges and practical implications

The report published on 12 September 2011 by the UK Independent Commission on Banking (ICB) will have far-reaching implications for the UK financial services sector. Its overall aims were to:

- ▶ Reduce the probability and impact of systemic financial crises in the future
- ▶ Maintain the efficient flow of credit to the real economy
- ▶ Preserve the functioning of the payments system and guaranteed capital certainty and liquidity for small savers and small and medium-sized enterprises (SMEs)

The proposed changes will have a serious impact on capital requirements, structural reform and competition. Within the context of improving financial stability, the report focuses on two main areas: ring-fencing to make it easier to resolve banks without recourse to taxpayers by insulating vital services and avoiding possible contagion effects, and competition to create greater choice for consumers through greater transparency, reducing barriers to entry to allow new players the ability to compete.

The main recommendations from the ICB were:

Ring-fencing:	Competition:
<ul style="list-style-type: none">▶ Retail deposit taking must be inside the ring-fence. Market facing activity must be outside. This leaves a large area of flexibility.▶ The ring-fenced bank (RFB) will be legally, economically and operationally separate, a "bank within a bank."▶ The RFB will require equity capital of at least 10% risk-weighted assets. (RWA)▶ Depositor preference for Financial Services Compensation Scheme (FSCS) deposits.▶ Services to non-RFBs and non-banking financial institutions are prohibited.▶ Services to clients outside the European Economic Area (EEA) are prohibited.▶ RFBs in place by 2019 at the latest.	<p>The UK banking markets will be referred to the Competition Commission by 2015 if any of the following are not met:</p> <ul style="list-style-type: none">▶ A strong and effective challenger has emerged from the Lloyds divestiture with a market share of at least 6% of personal current accounts.▶ A robust and risk-free redirection switching system for both personal and business current accounts has been implemented by September 2013.▶ A strong Financial Conduct Authority (FCA) has demonstrated progress toward increased transparency, reduced barriers to entry and growth by rivals to incumbent banks.
Financial stability	
<p>The entire business (not just the ring-fenced element) will need primary loss absorbing capacity of at least 17% to 20% (including bail-in bonds and contingent convertible bonds or CoCos).</p>	
<p>An extra 3% equity could be required if the bank is judged to be insufficiently resolvable.</p>	

"The ICB proposals have to be seen in the context of wider regulatory reform. By mid-2012, banks will have to have made clear decisions about the direction of travel on ring-fencing issues."

John Liver, EMEA Global Regulatory Reform Leader, Ernst & Young

Key considerations

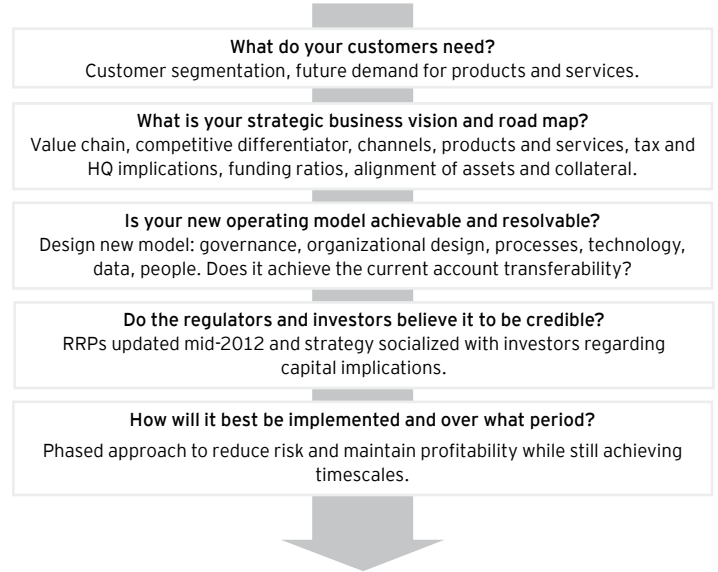
Although the changes will need to be implemented by 2019 at the latest, the reality is that banks will need to be designing that future today. While the banks will have choices and customers will have views about what sits inside the ring-fence, the recommendations are not prescriptive. Only retail deposit-taking and overdrafts are clearly in at present. It is likely that the Financial Services Authority (FSA) will require that the initial recovery and resolution plans (RRPs) due mid-2012 will need to outline a bank's views on what is in-scope for the RFB. The enhanced account switching solution also needs to be in place by Q3 2013 and will require industry-wide cooperation to achieve.

There are three key issues to consider within the overall context of financial stability:

1. Recovery and resolution planning	2. New business models	3. Competition and account redirection
The FSA's mid-2012 deadline for RRP's is of much greater significance than the ultimate deadline of 2019.	Creating a "bank within a bank": the degree of flexibility provided will lead to fundamental change.	Achieving the September 2013 deadline will require industry collaboration.

The design of the future business models (both RFB and rest of group) will necessitate the creation of RRP's for each transitional state. The FSA is likely to want to see early versions of these designs and plans in mid-2012.

In order to achieve this, each bank will need to consider a number of key questions as outlined below:



The report's recommendations will affect many of the existing cost reduction and service enhancement programs already being carried out within the banks. Deadlines are looming and work will need to start soon on designing the new operating models, dovetailing the new initiatives with the existing portfolio of changes and creating a phased implementation plan to reduce both risks and costs while maintaining business-as-usual (BAU) operations and profitability.

What does this mean for the banking system?

In the Executive summary, we outlined three key issues that will need consideration:

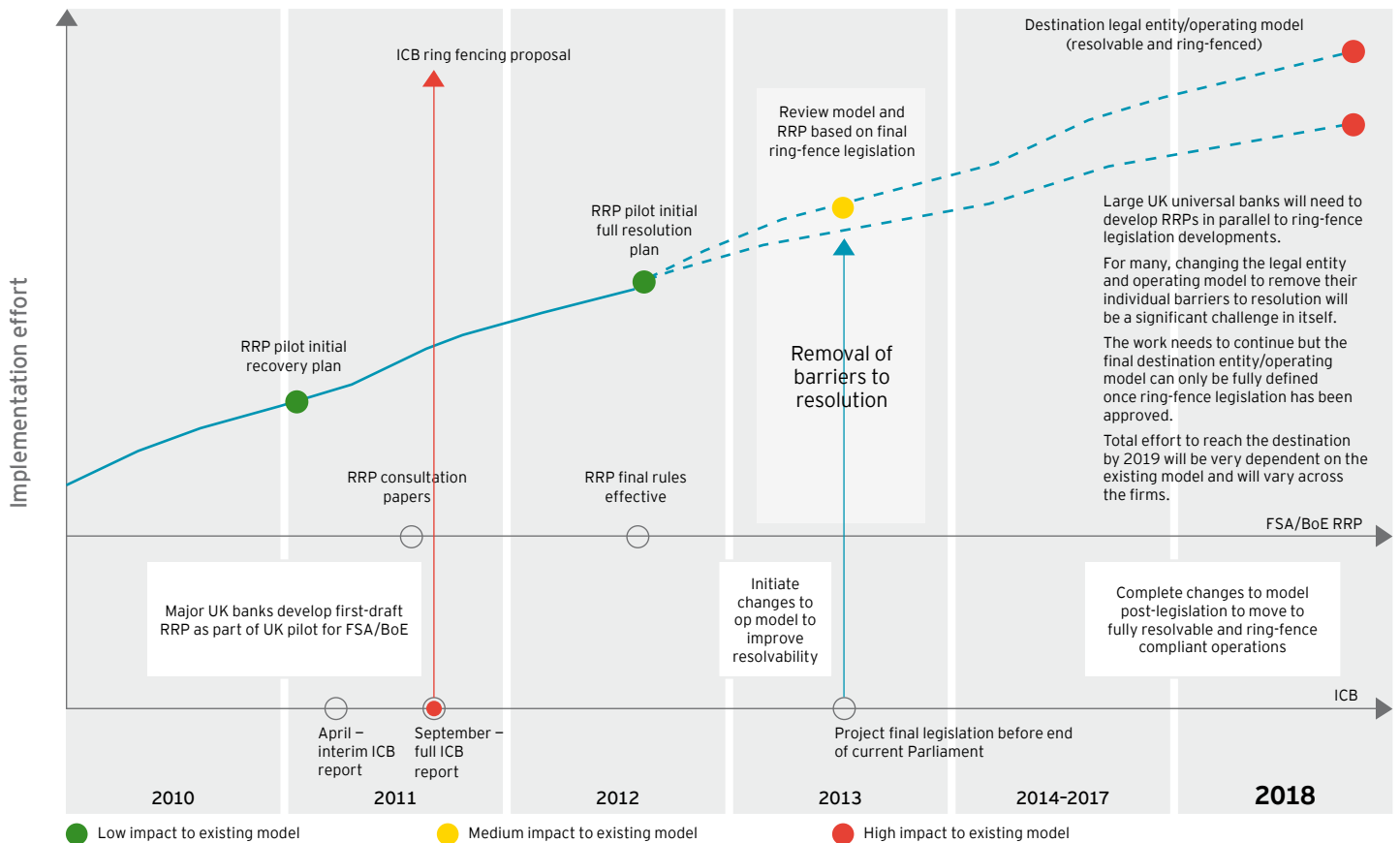
1. Recovery and resolution planning
2. Business model implications
3. Competition and account redirection

In the following section we have outlined these in more detail. Given the significant tax and accounting issues involved, we have provided a more detailed analysis of these specific issues in the next section.

1. Recovery and resolution planning

While the 2019 date is receiving a great amount of press coverage, the reality is that the large UK banks will need to be thinking about their new business models within the next 12 months. The implications for both the new RFB and the remainder of each group will be legally, economically and operationally complex to achieve. There will be a number of barriers to resolution that will need to be removed over the coming years but will be identified through the work required over the coming year. The new legislation may simplify and streamline some of the legal processes, but it is unlikely that the law will be enacted before 2015.

Project timeline of RRP and ICB ring-fence for large UK universal banks



The dialogue around RRP's will be ongoing. The FSA is likely to want to understand these new structures when determining whether it believes that the RRP's submitted in mid-2012 are credible. It is unlikely that any bank will be able to move to its future business model in one try; therefore, it is likely that there will need to be RRP's for each transitional state along the way to ensure resolvability at any point in time and achieve compliance with the emerging changes to the regulatory environment.

The implementation road map will be unique to each bank as it moves from its current to future operating state. Each will identify its own barriers to resolution that will need to be removed over the coming years.

“If the UK implements the ICB recommendations in full, it will be the boldest regulatory step taken in Europe in this arena.”

Andy Baldwin, EMEA Head of Financial Services, Ernst & Young

“As a result of the ICB recommendations, banks will have to hold extra loss-absorbing capital at group level. The market for these instruments is not yet proven and may have a major impact on costs.”

John Liver, EMEA Global Regulatory Reform Leader, Ernst & Young

2. Business model implications

The ICB’s recommendations will have broad-ranging implications for the structure, operations, cost base and value chains of the banks. The key recommendations are as follows:

- ▶ A robust yet flexible ring-fence should be put in place between UK retail banking operations and investment banking activities.
- ▶ UK retail banks should have equity capital of at least 10% of their RWAs with a consequent reduction in permitted levels of leverage.
- ▶ Large UK banking groups should have primary loss-absorbing capacity of at least 17% to 20%, which includes unsecured bank debt and CoCos that could be triggered to absorb losses.
- ▶ Banks will be able to decide whether to include big corporate deposits and loans in the ring-fence.
- ▶ Greater transparency and competition within the banking sector.
- ▶ Seamless redirection of individual and SME corporate bank accounts within seven days.
- ▶ Annual interest foregone disclosures (incorporating interest foregone relative to the Bank of England base rate into annual statements) should be issued to customers.

The ICB recommendations will fundamentally alter the business models of UK banks. By recommending that the RFB be a legally, operationally and economically stand-alone entity, the restructuring exercise is likely to make the existing costs of providing products and services across different entities and geographies more visible. The tougher RFB and group-level capital requirements will drive a review of the viability of existing services and models. The flexibility in the activities to be included means that what is carved in or out of the ring-fence will now be a much more strategic decision. It effectively creates a “bank within a bank” and will require each organization to consider the needs of its particular client and geographical location (inside or outside the EEA), creating new value chains and competitive differentiators, new product and service packages and associated channel and pricing structures.

The RFB could include all payment services together with many other corporate banking services for clients regardless of size. The positioning of payment services and its impact on corporate relationships will be important. As cost structures become more visible and the FCA demand greater transparency across the industry, the “free” banking model may also come under pressure.

Only once the organization is clear about where future profits are likely to come from – and where margins will be made – should the new operating model be designed. A key determinant for banks, in relation to the composition of their ring-fenced entity, will be the current relative size of retail and SME liabilities (i.e., deposits) compared to assets for the same customer groups. There will be significant accounting and tax implications as well as governance, process, people, technology and data issues to be resolved and designed – all at a time when the banks are already undertaking significant work in this area to reduce costs and improve efficiencies. This is why strategic thought needs to be given now to the future business model so that the portfolio of programs across each group can be realigned to the future vision of each company.

The banks will be pushed to think through the resolvability issues within the next year as part of their resolution planning. The FSA and other key stakeholders (e.g., the Bank of England, investor community) will want to see the future structures as soon as possible, as well as gain an understanding of the route map to achieving the changes, together with the associated costs and risks. The migration and transfer of assets and liabilities is an extremely complex process affected by a variety of factors such as funding, tax and Part VII transfers (i.e., of business assets and liabilities from one legal entity to another). The legislation (due in 2015) ideally will find ways to streamline the process and remove some of the obstacles that currently exist.

Considerations for that future design will include:

- ▶ Most FSCS-insured deposits, more than 95%, will be housed within the ring-fenced entity, but there is flexibility on where lending to large companies sits.
- ▶ The RFB must have its own governance and ensure that internal service level agreements with the rest of the group are similar to those for third parties.
- ▶ In designing the future legal entity and associated operating model, both ICB structural reform compliance and overall resolvability should be factored into the solution.
- ▶ The capital requirements of 10% RWA for retail banks and 17% to 20% for the group will create extra funding costs for the non-ring-fenced entity and will be a critical factor for decisions on where group headquarters would be located.
- ▶ The provision of key services to the RFB (shared infrastructure, for example) may reside within a separate entity. However, it is likely that any such entity would itself require protected working capital to support the provision of services during a financial crisis or resolution event.
- ▶ Existing group-wide service contracts and associated transfer pricing are likely to be affected. Balanced considerations are required in terms of capital management, liquidity, funding and tax against the financial stability objectives of simplicity and separability.
- ▶ Some firms may need to consider the implications for existing European branch networks in light of the changes to their UK structure, and many may be affected by a revised external ratings assessment.
- ▶ Our work to date in these areas suggest that the optimum approach is a well-considered, top-down design of the future business model together with some bottom-up simplification of less significant legal structures.
- ▶ The principle that prohibited services would include “any service which results in an exposure to a non-ring-fenced bank or a non-bank financial organisation, except those associated with the provision of payments services where the regulator has deemed this appropriate” will have important implications for the rest of the financial services sector. Non-bank organizations within financial services will also need to reflect upon the principles outlined within the report and consider any potential impact.

“It is sensible in such tight timescales that the Commission hasn’t pushed for full account portability. The proposals on transparency could galvanize consumer momentum to switch accounts. The seven-day timetable for account redirection will be a challenge for firms in these timescales.”

John Liver, EMEIA Global Regulatory Reform Leader, Ernst & Young

3. Competition and bank account transferability

The report is less clear about competition, although it does highlight the importance of the role that the FCA will play in increasing transparency, reducing barriers to entry and encouraging growth by rivals to the existing incumbents. It also recommends that the Lloyds Banking Group divestiture achieves a funding position in line with peers and a minimum market share of 6% of Personal Current Accounts for a new, strong and effective challenger.

In addition, by September 2013, it should be easier to switch current accounts for both individuals and SMEs through the early establishment of a robust and risk-free redirection service. This will require all of the banks to agree and collaborate over the coming months to determine how they will achieve these deadlines. While the immediate result may be a short-term, tactical solution, we believe that full account portability remains on the table for future policy consideration.

The ICB recommends “that interest foregone is included on customers’ annual statements, and that the FCA takes further action to require transparency in the future, such as making account usage information available to consumers electronically, or requiring that product ranges include a standardised option comparable across the industry.” This will have significant operational implications and will need to be considered when redesigning the business, operating and pricing models.

Accounting and tax perspectives

Accounting implications

The design will also need to take account of the specific accounting implications: while not explicitly stated in the report, it is anticipated that board appointments and replacements for ring-fenced entities will be within the control of the corporate group, as long as they are made in line with the independence framework recommended in the report. This relationship between the ring-fenced entity and the corporate group will be a key consideration in determining whether the ring-fenced entity would be deemed as a subsidiary and thus require consolidation into the group's financial statements. IFRS 10, *Consolidated Financial Statements*, is likely to be the prevailing statute in force when any restructuring occurs.

Additionally, the requirement for increased loss absorbency capacity may extend the use of instruments such as bail-in bonds and CoCos, which themselves throw up significant accounting considerations for both the issuer and investor. It will be important that both issuers and investors understand how the instrument will be classified and measured under IFRS 9, *Financial Instruments*, as this standard is expected to be effective for periods commencing on or after 1 January 2015.

Many of the broader accounting consequences will depend on the precise facts and circumstances, although it is likely that many complex accounting issues will arise. As new entities are created and assets and liabilities are transferred or sold, the appropriate accounting basis will need to be determined. Some of the specific accounting issues may include:

- ▶ **Goodwill and intangible recognition:** the basis upon which goodwill is currently assessed for impairment may not fit with the new group structure, thus leading to considerations of how this should be re-allocated and subsequently assessed. Similarly, consideration will be required for allocation of any intangible assets (such as customer lists), which sit across the ring-fence.
- ▶ **Hedging:** hedging relationships, and particularly cash flow hedges, that need to be re-designated (through one or both of the instruments moving entity) will cause recycling of movements on the old hedge relationship that were previously recorded in other comprehensive income through P&L. Additionally, hedging relationships that had been effective prior to re-designation may be less effective when re-designated in the new entity.

- ▶ **Segmental reporting:** changes how the business is managed will need to be reflected in the consolidated group financial statements. The need to restate for comparative purposes could be a substantial exercise depending on the extent of the restructuring.
- ▶ **Deferred tax:** consideration should be given as to where deferred tax assets can be carried into the new business structure. Additionally, some of the benefits gained from offsetting current deferred tax assets and liabilities could be lost.
- ▶ **P&L and reserve impacts:** there are many different issues that will need to be considered when defining the new structure (e.g., whether existing or new entities are used for the ring-fenced, non-ring-fenced and central functions). These could have a significant effect on distributable reserves in the separate legal entities. Banks will need to consider which assets and liabilities are to be transferred in order to effectively manage the tax and regulatory consequences as well as the impact on distributable reserves. This may be particularly important where the fair value of a financial instrument is not equal to its carrying value.

Tax implications

The ICB recommends that a bank's UK retail activities must be carried out in separate subsidiaries that are legally, economically and operationally separate from the rest of the banking group. The tax implications of this, both UK and foreign, will be highly significant.

UK banks that conduct both retail and investment banking businesses in the UK will be required to enter into some form of internal corporate restructuring of their operations to comply with the structural reform being proposed. This may involve transferring business lines and assets intra-group, creating branch network and operational subsidiaries, and raising Basel III-compliant regulatory capital and liquidity pools.

The proposed restructuring may result in an immediate tax cost (such as the loss of tax attributes or the crystallization of unrelievable chargeable gains and potential non-UK tax charges) as well as continuing group tax inefficiencies (such as a loss of flexibility for deferred tax asset (DTA) utilization and potential loss of tax groupings and efficient relationships between ring-fenced sub-groups and the wider banking group).

Where possible, existing tax legislation should be used to exempt, mitigate or defer a tax charge on implementation of structural reform. It is for Her Majesty's Treasury and Revenue & Customs (HMT and HMRC, respectively) to consider whether access to current reliefs should be facilitated on group restructuring implementation. In some cases, it may be necessary to legislate in this area, so the period of discussion for the ring-fencing proposals generally should be used to engage with HMRC on these proposals and their tax implications.

It is anticipated that tax policy decisions will likely focus on two core issues:

- ▶ How the stability of the financial sector is to be maintained during implementation of the proposed structural reforms
- ▶ How to ensure the continued competitiveness of the UK as a financial services hub

Both are clearly in the interest of the wider real economy, and it is yet to be seen whether, as a matter of tax policy, banks (as part of the private sector) should benefit from a more lenient tax regime on implementation of the structural reform.

The ICB's report also makes it clear that the required primary loss-absorbing capacity of between 17% and 20% of RWAs may, in part, be met by a combination of bail-in bonds – understood to mean additional going concern capital (AGCC) and long-term Tier 2 instruments – and contingent securities. However, because banks will be required to rely heavily upon the equity markets to meet both Pillar 1 common equity requirements and Pillar 2 capital conservation and counter-cyclical buffers, it is imperative that capital market and fixed-income investors find these types of instruments sufficiently attractive in order for banks to meet these loss-absorption levels.

A key consideration will be the tax treatment of these instruments. In particular:

- ▶ The deductibility from taxable profits of the cost of financing
- ▶ The potential "claw back" (i.e., an up-front tax charge) for the issuer at the point of loss absorption

This second point is particularly significant. Under the EU's Capital Requirements Directive IV (CRD IV), it has been confirmed that regulatory capital recognition at the date of issuance should be net of any potential tax charge – although how this will be achieved under enacted legislation is still to be agreed.

Tax areas to consider under new ring-fencing requirements will include:

Tax attribute preservation	Potential immediate loss of DTAs in the context of separation of retail banking business from a “universal banking trade”; implications for forecasting and DTA recognition on separation of, for example, losses from sources of taxable income.
Independent governance	Tax grouping definitions that rely on the “control” test (meaning the power of a person to secure that the affairs of the company are conducted in accordance with the person's wishes) may be affected by the requirement that the board of the UK retail subsidiary has a majority independent director, one of whom is the chair.
Transfer pricing	Any reorganization or business restructuring to separate retail and investment banking activities will ultimately lead to the redeployment of functions, assets and risks. This in turn will lead to a reallocation of profits among members of the group. This reallocation of profits will need to be consistent with the arm's length principle and comply with Chapter IX of the OECD Transfer Pricing Guidelines. The ICB recommends that ring-fenced banks should be required to disclose all inter-group transactions and exposures on a regular basis and demonstrate that these are taking place on a commercial and arm's length basis.
Capital gains analysis and planning on reorganizations	There are a number of ways in which a reorganization to separate out retail and investment banking functions might be achieved, from a simple hive-down of assets to more complex demerger structures. In each case a significant risk to be managed will be the realization of latent chargeable gains or losses on a disposal of chargeable assets. There are a number of UK reliefs which may be available to either exempt or defer the realization of a chargeable gain or allowable loss for corporation tax purposes.
Financing and liquidity structures	Due to the increased focus on primary loss-absorption, the tax implications for both the issuers and holders of capital debt instruments (including debt buybacks and bail-in) are important. In particular, where a retail banking subsidiary issues such instruments to the market, there is the potential for it to be “de-grouped” from a tax perspective. This issue is already being considered by HMRC in the context of the discussions on taxation of regulatory capital instruments.
Operational taxes	Banks that currently deal in securities within the same corporate entity as that which carries on retail banking are likely to have to consider their Stamp Duty Reserve Tax (SDRT) recognized intermediary (RI) position. If such a bank moves its securities dealing business to a new corporate entity, that new entity would need to ensure it qualifies for RI status and then would have to apply (whether via membership of an exchange or directly to HMRC) for that status.
Foreign tax implications of subsidiaries	Global universal banks with operations overseas may also have to consider both UK and foreign tax implications of any restructuring (such as the potential crystallization of a UK tax charge on the subsidiarization of a foreign branch).
Bank Levy	Independent governance may also have implications for the calculation of the UK Bank Levy where this may cause deconsolidation of the retail sub-group (such as the application of the netting provisions).
Customers	Transferring contracts to or from a retail banking subsidiary may trigger adverse tax consequences for the bank's clients, which will need to be addressed.

Conclusion

The ICB recommendations that the new ring-fenced banks be legally, economically and operationally stand-alone entities will require the development of new business models. It is likely to make the cost of service provision more apparent internally and drive a different dialogue at the strategic level regarding which customer segments require which services in which geographies, and how much customers are prepared to pay for them.

This could conceivably lead to a very different packaging of products and services, through different channels and with different pricing models. The future value chain should, in part, drive the decisions about what sits inside and outside the ring-fence – the future business needs to be profitable and sustainable, in the first instance, as well as being resolvable.

The deadlines for the initial RRP (mid-2012) and the account redirection within seven days (September 2013) are relatively close. This means that work should start now on defining the new strategy and value propositions, designing the future business and operating models and creating the road map that leads to implementation before 2019. The road map will need to consider how best to minimize risk, cost and the impact on BAU while maintaining profits.

“The recommendations represent a significant challenge for the banking industry and will have far-reaching implications for the whole of the UK financial services sector.”

Niamh Prendergast, UK Banking & Capital Markets Leader, Ernst & Young



Contact details



John Liver

EMEIA Global Regulatory Reform Leader

T: +44 (0)20 7951 0843

M: +44 (0)7717 736 246

E: jliver1@uk.ey.com

John is a partner in Ernst & Young LLP's Financial Services Advisory practice. He leads our EMEIA Global Regulatory Reform team and chairs our global Financial Services regulatory compliance solution network. John leads support programs for clients looking to resolve regulatory challenges, manage and benefit from regulatory change, and deal with the regulatory aspects of business change.



Niamh Prendergast

UK Banking & Capital Markets Leader

T: +44 (0)20 7951 3616

M: +44 (0)7885 081 005

E: nprendergast@uk.ey.com

Niamh has worked in financial services for 20 years and currently heads our Banking & Capital Markets Industry practice for the UK and Ireland. She is a member of our EMEIA Banking Industry Board and Head of Diversity and Inclusiveness for Financial Services.

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