Report: U.K. Bank Ring-Fencing Legislation

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TABLE OF CONTENTS

	EXECUTIVE SUMMARY	4
1.	INTRODUCTION AND BACKGROUND	7
2.	THE DEFINITION OF “CORE SERVICES”	8
3.	RING-FENCING TRANSFER SCHEMES	11
4.	THE DEFINITION OF “EXCLUDED ACTIVITIES”	16
5.	THE PROHIBITION ON “FINANCIAL INSTITUTION EXPOSURES”	21
6.	LIQUIDITY MANAGEMENT FOR RING-FENCED BANKS	34
7.	THE IDENTIFICATION OF THE “ACCOUNT HOLDER”	39
8.	APPLICATION TO TAX EXPOSURES	41
9.	THE APPLICATION OF THE REGIME TO TRADE FINANCE PRODUCTS	45
	APPENDIX	47

EXECUTIVE SUMMARY

The U.K.'s legislative regime for ring-fenced banks is provided by Part 9B of the Financial Services and Markets Act 2000 ("**FSMA**"), as inserted by the Financial Services (Banking Reform) Act 2013 (the "**BRA**"). Under this Part were made the Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014 (SI 2014/1960) (as amended) (the "**CAO**"), which broadly sets out the conditions under which a bank is a ring-fenced body, and the Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014 (SI 2014/2080) (as amended) (the "**EAPO**"), which specifies the restrictions and prohibitions to which ring-fenced bodies are subject.

The implementation of the bank ring-fencing regime in the U.K. has given rise to several issues of legal uncertainty. In this Report, the FMLC has sought to identify these legal uncertainties, explain their impact on market participants, and make recommendations on how each might be resolved. Other uncertainties also arise in the context of the regime which may be considered primarily policy-related; the FMLC's remit, and therefore that of the Report, is to address only the legal uncertainties.

Some of the key legal uncertainties identified in the paper are summarised below:

1. ***The definition of the "core services":*** The expression "core services" is used to inform the statutory objectives of the U.K.'s financial services regulators under the ring-fencing regime. Its ambit is wider than that of the "core activities" on the basis of which institutions are brought into the scope of the regime and it is therefore unclear whether it is intended to cover the activities of, for example, platforms operated by non-ring-fenced banks, or non-banks, through which deposits may be made with ring-fenced banks.

2. ***The meaning and ambit of ring-fencing transfer schemes:*** It is unclear whether it is possible to transfer, from the ring-fenced bank to the non-ring-fenced bank within a group, part of a relationship with a particular customer (rather than the entire relationship) under Part VII of FSMA or under the Banking Act 2009. This has particular impact on acquisitions by a banking group, including in a "rescue" scenario. The FMLC recommends that any "business or asset and/or liability" transaction between two such banks were allowed to fall within the scope of Part VII.

3. ***Excluded activities not subject to the regime:*** The EAPO specifies that dealing in investments as principal (Article 4) and dealing in commodities as principal (Article 5) are excluded activities—i.e., engaging in them may be considered a contravention of

regulatory requirements, subject to certain exemptions. The regime has created considerable uncertainty and complexity in the structuring of securitisation and covered bond arrangements involving assets originated by ring-fenced banks. The FMLC recommends clarificatory wording and/or regulatory guidance on the interpretation.

4. ***The prohibition on incurring exposures to range of financial institutions and exceptions to it:*** Under Article 14(1) of the EAPO, a ring-fenced body is prohibited from incurring a "financial institution exposure" to limit the extent to which it is exposed to risk taking and failure in financial institutions that are not ring-fenced bodies. Amongst other things, the meaning and definition of "exposure" as well as when one might be "incurred" are not clear. The legislation includes some exemptions from this prohibition, in relation to which the FMLC has identified further legal uncertainties.

5. ***Liquidity management for ring-fenced banks:*** Ring-fenced banks are permitted to deal in investments as principal provided the "sole or main purpose" of the transaction is to limit the extent to which "liquidity risk" adversely affects the ring-fenced bank. This test has had practical consequences for ring-fenced banks' liquidity management operations. The FMLC expresses the view that the exemption should be restated so that it permits the activity of "dealing in investments as principal" to take place where this is part of a broader liquidity management programme. It also suggests that the "adverse effect" test is removed.

6. ***The identification of the "account holder":*** The concept of "account holder" determines whether the account concerned is a "core deposit," while a bank's total core deposits determine whether it is exempt from the ring-fencing regime. Definitional uncertainties arise where legal and beneficial ownership of a deposit are split, particularly as the legislation does not specify whether the account holder is the legal or beneficial owner. The FMLC urges authorities to provide clarification to ensure that the scope of ring-fencing is applied consistently.

7. ***Tax exposures:*** Taxes imposed in the U.K. are imposed primarily on particular legal entities rather than on groups as a whole: as a result, ring-fenced bank should not have a legal obligation in respect of any U.K. tax exposures of a non-ring-fenced-entity. There are, however, instances under VAT legislation where one group company can incur liability for VAT arising from the activities of another company in the same VAT group. There is, an exemption in Article 14(4) of the EAPO which permits ring-fenced banks to incur exposures to financial institutions that result from transactions with

other members of their group; but the application of this exemption to contingent exposures of this kind arising within VAT groups is uncertain. The FMLC recommends that this uncertainty be resolved by either amending relevant tax rules applicable to VAT groups or by providing additional guidance in relation to the group transactions exemption in Article 14(4) of the EAPO.

8. ***The application of the regime to trade finance products:*** Ring-fenced banks may, as an exemption from the prohibition on incurring financial institution exposures, enter into certain transactions in connection with trade finance under which they do incur such exposures. There is, however, legal uncertainty about how this exemption applies to some market standard trade finance products. Clarity would be helpful as to which standard trade finance products fall within the scope of this exemption.

The FMLC is aware of the appointment by HM Treasury of an independent panel to review the operation of the legislation relating to ring-fencing (the "**RFPT Review**").[4] Should the RFPT Review's findings cause HM Government to amend the bank ring-fencing legislative framework, the FMLC would urge that any such amendments also address the issues identified in this Report. The FMLC has sent a copy of this Report to the Chair of the RFPT Review.

[4] FMLC Letter: *Ring-fencing and Proprietary Trading Independent Review*, 1 June 2021; available at: http://fmlc.org/wp-content/uploads/2021/06/FMLC-letter-to-Independent-Review-on-ring-fencing.pdf

1. INTRODUCTION AND BACKGROUND

1.1. The role of the Financial Markets Law Committee (the "FMLC" or the "Committee") is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

1.2. As part of its response to the global financial crisis of 2008, HM Government introduced legislation requiring U.K. banks to separate the provision of core retail services from other activities within their groups. These requirements are known as "ring-fencing." The U.K.'s ring-fencing regime broadly covers U.K. banks with more than £25 billion of core (retail and SME) deposits and has applied since 1 January 2019. The legislative basis for this regime is provided by Part 9B of the Financial Services and Markets Act 2000 ("**FSMA**"), as inserted by the Financial Services (Banking Reform) Act 2013 (the "**BRA**"), under which the Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014 (SI 2014/1960) (as amended) (the "**CAO**") and the Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014 (SI 2014/2080) (as amended) (the "**EAPO**") were made. In broad terms, the CAO sets out the conditions under which a bank is a ring-fenced body and the EAPO specifies the restrictions and prohibitions to which ring-fenced bodies are subject, including "excluded activities" (and exceptions to those restrictions and prohibitions). In this Report, the terms "ring-fenced body" and "ring-fenced bank" are used interchangeably.

1.3. The implementation of the ring-fencing regime for U.K. banks in 2014 represented a substantial change to the structure of the U.K. banking sector. In February 2013, the FMLC published a report examining issues of legal uncertainty arising from the then draft Financial Services (Banking Reform) Bill (the "**2013 Report**")[5] In October that year, the FMLC published a further report, highlighting legal uncertainties in the same context, following the publication by HM Treasury of draft statutory instruments and a formal consultation (the "**2013 Addendum**").[6] In the time since the 2013 Report and Addendum were published, the U.K.'s bank ring fencing regime has come into operation. Many of the issues identified by the FMLC's 2013 publications remain, however, unresolved, or not satisfactorily resolved. While significant changes were made to the draft secondary

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[5] FMLC: *Banking Reform (Ring-Fencing)* (February 2013); available at: http://fmlc.org/wp-content/uploads/2018/03/Issue-175-Banking-Reform-Ring-Fencing-Report.pdf

[6] Addendum (October 2013); available at: http://fmlc.org/wp-content/uploads/2018/03/Issue-175-Addendum-to-Banking-Reform-Report.pdf

legislation considered by the 2013 publications, the enacted legislation did not address the issues of legal uncertainty that were identified. In addition, further issues of legal uncertainty in the legislation have arisen or have only been fully appreciated since 2013.

1.4. In the context of these enduring uncertainties, the FMLC has established a Working Group to consider and address the issues of legal uncertainty arising under the U.K. bank ring-fencing regime and to make recommendations on how they might be resolved. This Report sets out several disparate legal uncertainties arising from regime. This Report attempts to explain some of the most important uncertainties, to describe their impact on market practice and to suggest means by which the uncertainties may be resolved. The Appendix collates the FMLC's recommendations for ease of reference.

2. THE DEFINITION OF "CORE SERVICES"

Background

2.1. The ring-fencing regime's requirements apply, under the BRA, to all those institutions that carry out the "core activity" of accepting deposits, unless exempted by secondary legislation. The ring-fence is further scoped by the CAO by defining the threshold below which institutions will be exempted from ring-fencing and the exemptions which permit deposits of larger organisations and high net worth individuals to be held outside the ring-fence. A second concept, that of "core services," exists under the ring-fencing regime to inform the statutory objectives of the Financial Conduct Authority (the "**FCA**") and the Prudential Regulatory Authority ("**PRA**") with regard to ring-fenced banks and to form the basis of the power of HM Treasury to make secondary legislation under FSMA concerning ring-fenced banks. "Core services" are defined in section 142C (2) of FSMA as:

a) facilities for the accepting of deposits or other payments into an account which is provided in the course of carrying on the core activity of accepting deposits.

b) facilities for withdrawing money or making payments from such an account; and

c) overdraft facilities in connection with such an account.

2.2. Section 1EA of FSMA sets out the FCA's continuity objective under which it is to protect the "continuity of the provision in the United Kingdom of core services." The FCA is required therefore to ensure that the business of ring-fenced bodies is carried on in a way that avoids any adverse effect on the continuity of provision (referred to below as "service continuity"); ensure that the business of ring-fenced bodies is protected from risks that

could adversely affect service continuity; and minimise the risk that the failure of a ring-fenced body or of a member of a ring-fenced body's group could adversely affect service continuity. The PRA is subject to similar statutory objectives in this regard.[7]

2.3. In utilising its powers to make secondary legislation under FSMA, HM Treasury must ascertain that the order it seeks to make is not likely to have a significant adverse effect on service continuity. This would apply, for example, if HM Treasury seeks to make an order:

(a) under section 142A (2)(b) exempting a class of U.K. institutions from the definition of a "ring-fenced body" (section 142A (3))

(b) under section 142D (2) specifying circumstances in which the regulated activity of dealing in investments as principal (whether carried on in the U.K. or elsewhere) is not an excluded activity that a ring-fenced body is prohibited from carrying on (section 142D (3));

(c) under section 142D (4) providing for an activity other than the regulated activity of dealing in investments as principal to be an excluded activity, either generally or when carried on in circumstances specified in the order; or

(d) prohibiting ring-fenced bodies from carrying on certain activities.[8] When deciding whether to make such an order, HM Treasury must, among other things, consider whether the doing of that thing by a ring-fenced body would make it more likely that the failure of the body would have an adverse effect on service continuity.

Issues of legal uncertainty

2.4. It is clear that the definition of "core services" goes beyond the "core activity" of taking deposits which is, in relation to certain depositors, confined to ring-fenced banks in banking groups to which the ring-fencing regime applies under FSMA. "Core services" include facilities for the accepting of deposits or other payments into an account which is

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7 See section 3I of FSMA.

8 These activities include

i. entering into transactions of a specified kind or with persons falling within a specified class;

ii. establishing or maintaining a branch in a specified country or territory; or

iii. holding in specified circumstances shares or voting power in companies of a specified description

provided in the course of carrying on the core activity of accepting deposits, and facilities for withdrawing money or making payments from such an account. If the broadest sense of the word "facilities" is considered, firms other than banks may be found to be involved in the provision of these services, but it is not clear whether the expression "core services" is intended to cover the activities of, for example, platforms operated by non-ring-fenced banks, or non-banks, through which deposits may be made with ring-fenced banks, or the activities of payment services institutions that are not banks. In addition, the third limb of the definition of "core services"—"overdraft facilities in connection with such an account"—appears to apply the term "facilities" in a different sense to that in which it is used in the context of the acceptance of deposits and payments, given the broad understanding of the expression "overdraft facility" as the contractual or other arrangement agreed by the bank with the depositor under which the depositor may draw funds from the bank that exceed the balance on the relevant deposit account. Given the potentially more expansive sense in which the term "facilities" is used in the other limbs of the definition of "core services," it would be helpful if this were clarified so as to provide certainty around the regulators' powers and objectives and the powers of HM Treasury to make secondary legislation.

2.5. Before exercising its powers noted above, HM Treasury is required to consider the effect that this would have on the continuity of the provision in the United Kingdom of core services. It is not entirely clear how HM Treasury has done this or should do this in the future. The continuity of core services is often determined, and indeed may be secured, by matters outside the ring-fencing regime, for example, the ability of depositors to move their deposits to another bank in the ordinary course or the ability of the Bank of England to exercise its powers as resolution authority under the Banking Act 2009 to require and effect such a transfer. The ordinary portability of deposits is expected to increase in the future, particularly with the adoption of new technology and depositor expectations of flexibility. This raises a question of whether judgments that HM Treasury has made on the utility of secondary legislation in securing continuity of core services at a time when deposits were less portable will remain valid in the future. It seems that HM Treasury's judgment need only be made when (or before) such secondary legislation is made, but when that legislation is amended there is a question of whether HM Treasury is required to reassess its utility against the statutory requirements noted above.

<u>Solutions and mitigants</u>

2.6. The statutory objectives of the FCA and the PRA, and the powers of HM Treasury to make secondary legislation to support the ring-fencing regime, focus on preserving the

continuity of core services in the U.K. It is therefore important that there is clarity on the activities that comprise those services. It would be helpful if the definition of "core services" in section 142C of FSMA were amended (i) to make clear to which firms the references to accepting deposits, providing facilities for withdrawing money and providing overdraft facilities in that definition are intended to refer and (ii) to clarify what is meant by 'facilities' in that definition and whether this is intended to refer only to facilities provided by banks or to extend also to facilities provided by other service providers. It would also be helpful if, when amending the CAO and/or the EAPO in the future, HM Treasury would state clearly how each element of the amended legislation is consistent with the continuity objective referred to above.

3. RING-FENCING TRANSFER SCHEMES

Background

3.1. Section 106 of FSMA allows business to be transferred from a ring-fenced bank to a non-ring-fenced bank by way of a ring-fencing transfer scheme under Part VII of FSMA. A ring-fencing transfer scheme might be required (i) at the outset when a bank is establishing a ring-fence or (ii) during the life of the ring-fenced bank where, for example, the regulator makes new rules to ensure that the carrying on of core activities by a ring-fenced body is not adversely affected by acts or omissions of other persons, and that a ring-fenced body which is a member of a group can act independently of other members of that group in carrying out its business. It may also be a convenient way of implementing a Mergers and Acquisition transaction. The threshold above which a group containing one or more U.K. banks becomes subject to the ring-fencing regime is currently set out in Article 12 of the CAO at £25 billion of "core deposits", averaged over three consecutive financial years in accordance, and calculated in aggregate across all U.K. banks in the group concerned. Where a group contains more than one U.K. bank, once this threshold is exceeded, all U.K. banks in the group that take "core deposits," regardless of their size, are treated as ring-fenced banks under the regime.

3.2. Ring-fencing transfer schemes are discretionary, being subject to the sanction of the court They are subject to the existing conditions for banking business transfer schemes under Part VII of FSMA and specific conditions, particularly those set out in Section 109A of FSMA, which require an independent report specifically addressing adverse effects of third parties. In addition to the court being satisfied that certain procedural requirements have been satisfied, the court must, pursuant to Section 111(3) FSMA, consider that, in

all the circumstances of the case, it is appropriate to sanction the scheme. In assessing whether to grant permission for the transfer, the court will seek to give due recognition to the commercial objectives and judgments of the boards of the transferor and transferee (*Re London Life Association Ltd*).[9] The main consideration for the court, however, is whether the transfer is fair as between the interests of different classes of affected person. Relevant to whether the court sanctions a ring-fencing transfer scheme is the right to participate in proceedings. Section 110 of FSMA provides that, on an application under section 107, the PRA and the FCA (where the transferee is an authorised person), and any person (including an employee of the authorised person concerned or of the transferee) who alleges that he would be adversely affected by the carrying out of the scheme are also entitled to be heard.

3.3. Neither Part 9B of FSMA, nor the secondary legislation made under that Part, provides for any "grace period" during which a U.K. bank that has been acquired by a group that is subject to the ring-fencing regime need not comply with the requirements for a ring-fenced bank. This means, for example, that a small bank that has not been run to comply with the regime must comply fully with the regime from the time its acquisition by a group that is subject to the regime is completed. It also means that a group containing a U.K. bank that is not subject to the regime benefits from no grace period to adjust to the regime when that group acquires a group containing a ring-fenced bank.

<u>Issues of legal uncertainty</u>

Issues specific to ring fencing transfer schemes

3.4. It is unclear whether it is possible to transfer part of a relationship with a particular customer (rather than the entire relationship) under any of the possible options for achieving this including under Part VII of FSMA or under the Banking Act 2009,

[9] The court will also consider certain principles established in *Re London Life Association Ltd* (February 21, 1989, unreported), which remains relevant although it concerned an application for an insurance business transfer rather than banking business transfer under the law which preceded Part VII of FSMA. These points include:

a) the effect of the transfer on policyholders' (or, in the case of a banking business transfer, account holders') rights and security;

b) whether any policyholder (or, in the case of a banking business transfer, account holder), employee or other interested person will be adversely affected;

c) procedural matters, such as whether policyholders (or, in the case of a banking business transfer, account holders) have been notified; and

d) the opinion of the PRA and, where relevant, the FCA.

although it has been accepted in practice that this may be appropriate, for example where the ring-fenced bank will not provide some of the services which the customer took from its predecessor. Another example of where this issue might arise is where a derivative contract with a particular counterparty is required to be transferred out of the ring-fenced bank and the same counterparty has an amount deposited with the bank which is to remain within the ring-fence. Although, section 106B refers to a transfer of "part of the business carried on by a U.K. authorised person", it is unclear whether part of a relationship with a customer can be transferred from a ring-fenced bank to a non-ring-fenced bank. In terms of scope, the regime only applies to a "business" rather than also allowing "assets" to be included. The restriction of transfers to a "business" ultimately creates uncertainties around whether parts of client relationships are in scope. A difficulty in some transfers is that it may be doubtful that a "banking business" is constituted by a series of customer accounts, receivables, or customer assets—typically, a "business" would also include some IP, software (which may be licensed centrally and may not need transferring) or other intangible assets and liabilities and some employees (who may not be transferring, whether due to outsourcing or similar). This legal uncertainty might arise in both situations outlined above (that is, (i) at the outset when a banking group is establishing a ring-fence; and (ii) during the life of the ring-fenced bank, where there is a transfer of business which, if it were maintained in the ring-fenced bank, would cause a ring-fencing contravention). Secondly, legal uncertainty arises *ab initio* from the court's discretion under section 111 of FSMA as to whether to grant permission for the transfer of banking business. Again, this legal uncertainty might arise both (i) at the outset when a bank is establishing a ring-fence; and (ii) in the life of the ring-fenced bank.

3.5. Even in a solvent situation, if the court were to refuse its permission for the transfer of banking business under section 106B, the consequence may be that the business, which is not permitted to be maintained in the ring-fenced bank, would have to be terminated. In the same way, the part of the client relationship which is not permitted to be held in the ring-fenced bank may have to be terminated if it is not possible to transfer part of a relationship with a client under section 106B. These effects could fall particularly on growing challenger banks whose core deposits may foreseeably pass the ring-fencing threshold in the future.

Acquisition by a banking group (including in a "rescue" scenario)

3.6. The complexity of the ring-fencing regime is such that it may be impossible to gain assurance, prior to the completion of an acquisition, that immediate compliance with the regime will be possible. This may, in turn, inhibit "rescue" transactions under which a

large banking group that is subject to the regime acquires a bank in financial difficulty that is not subject to the regime. This may have the follow-on consequences of preventing obligations to some creditors from being met in full, which may have been possible had the transactions in which they arose been able to be included in the transferred business, subject to a period of adjustment for disposal or winding up of the transactions concerned. In addition, different components of a relationship with a customer may be treated differently, contrary to the principles in the Banking Act 2009.

3.7. In addition, legal uncertainty arises in relation to the status of commitments that such a bank made prior to becoming a ring-fenced bank: for example, a commitment to sell securities that is made before the acquisition of the bank but would be unlawful for the bank to complete as a ring-fenced bank. There is no provision addressing this point in the legislation. This point also arises more generally when a bank that is not subject to the regime grows in size to the point where it meets the requirements for a ring-fenced body in the CAO (or otherwise becomes subject to the regime as a result of the volume of deposits in U.K. banks in the group of which it forms part).

3.8. As well as difficulties in effecting a contractual transfer of a non-ring-fenced banking business into a ring-fenced bank or dealing with the effects of growth by a non-ring-fenced bank past the ring-fencing threshold, there may also be difficulties in using a ring-fencing transfer scheme under section 106B of FSMA to achieve a business transfer owing to objections from affected parties, who may be adversely affected by a business transfer that is required to secure compliance with the regime. It is also impossible to comply with the "keep-together" provisions under the Banking Act 2009 for transfer of relationships from a non-ring-fenced bank to a ring-fenced bank in a case of failure of a non-ring-fenced bank, and this may seriously disadvantage some customers and other counterparties.[10]

Solutions and mitigants

3.9. Insofar as uncertainty exists regarding whether part of a relationship with a customer could be transferred under Part VII of FSMA and the consequent rights of customers to object to separation, this may be staved off by providing the court with a degree of discretion, where this would be fairest, to provide that certain relationships be kept together (whether all are transferred into the new business, or all kept in the continuing one), with permission for the ring-fenced bank (or the non-ring-fenced bank) to run-off any otherwise unpermitted activities it would have as a result of the keep-together

[10] The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009

provisions. Another way by which the above uncertainties may be reduced is if any "business or asset" transaction between two such banks were allowed to fall within the scope of Part VII.

3.10. The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 (as amended) (the "**Safeguards Order**") aims to reduce disruption to a business's contractual rights and methods of reducing credit risk caused by the existence of partial property transfer powers. One way in which the Safeguards Order achieves this objective is by restricting the transfer of some, but not all, of the protected rights and liabilities between a particular person and a banking institution under a particular set-off arrangement, netting arrangement or title transfer financial collateral arrangement (section 3(1) Safeguards Order). At present this may not be possible in relation to a ring-fenced bank if that bank cannot take on some of the services the subject of the arrangement, and this might affect the rescue options. The recommendations in paragraph 3.9 would address this issue and an express reference could be added to the Safeguards Order for instances where a ring-fenced bank is a transferee. It seems highly desirable that these changes are made because they would be compatible with competition between challenger and ring-fenced banks and would afford flexibility for the authorities to deal in the best possible way with failures of challenger banks, while minimising unfairness to customers.

3.11. When a business transfer is made to a ring-fenced bank, time may be needed for the ring-fenced bank to address all the relationships it has acquired. In case of urgency, there may not be time to examine them all in advance and make sure they are dealt with in the order of the court sanctioning the ring-fencing transfer scheme under which the business is transferred. It would be helpful if the court had power, in such circumstances, to allow a grace period within which the bank may examine relationships and, before the end of which, either transfer prohibited arrangements to a non-ring-fenced institution or apply to the court for a derogation to allow the relationships to run-off.

3.12. While to date, the transfers of assets and/or liabilities not constituting a business have not proved to be a practical problem, future problems would be avoided if the court could also authorise a transfer of assets and/or liabilities which do not constitute a business. This could be achieved by means of a minor amendment to the powers in FSMA.

4. THE DEFINITION OF "EXCLUDED ACTIVITIES"

Background

4.1. Section 142D (2) of FSMA provides that the regulated activity of dealing in investments as principal (whether carried on in the U.K. or elsewhere) is an excluded activity, save in circumstance that HM Treasury may specify by order.[11] Section 142G provides that it is a contravention of regulatory requirements for a ring-fenced body to carry on an excluded activity. Section 142Z1 further provides that the reference to dealing in investments as principal is to be read in accordance with Schedule 2 to the FSMA (which contains a list of "investments") and any order under section 22 of the Act (namely, the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544) (as amended) (the "**RAO**")). Article 4 of the EAPO specifies dealing in investments as principal as an excluded activity. For this purpose, "dealing in investments as principal" is described in Article 14 of the RAO as

1. Buying, selling, subscribing for or underwriting securities or contractually based investments (other than investments of the kind specified by article 87, or article 89 so far as relevant to that article) as principal is a specified kind of activity

2. The RAO provides situations in Article 15 to 20 in which dealing in investments as principal may not be an excluded activity but, under Article 4 of the EAPO, the exclusions in Articles 15, 19 or 20 of the RAO, are to be disregarded in the context of ring-fenced banks.

Issues of legal uncertainty

4.2. The exclusions in Articles 17, 18 and 18A of the RAO, however, are not mentioned in Article 4 of the EAPO, suggesting that these exclusions apply to ring-fenced banks engaging in the excluded activity of dealing in investments as principal. Consequently, ring-fenced bodies would be allowed to accept and acknowledge indebtedness from a borrower without it being viewed as dealing in a debenture as principal (Article 17) and would be allowed to purchase its own shares and deal in treasury shares as principal

[11] An order under subsection (2) may be made only if the Treasury are of the opinion that allowing ring-fenced bodies to deal in investments as principal in the specified circumstances would not be likely to result in any significant adverse effect on the continuity of the provision in the United Kingdom of core services.

(Article 18A).[12] It would appear, however, that the Article 18 exclusion is overridden by Article 4(4) of Directive 2014/65/EU ("**MiFID II**"), as onshored by The Markets in Financial Instruments (Amendment) (EU Exit) Regulations 2018 (together "**U.K. MiFID II**") giving rise to uncertainty regarding whether a ring-fenced body that carries on investment services would be able to rely on Article 18 to issue its own shares, debentures and warrants. Article 6(4)(b) of the EAPO allows a ring-fenced body to deal in debentures or instruments giving an entitlement to shares or debentures issued by it or its subsidiary, but it does not seem to state that a ring-fenced body may issue its own shares.

4.3. Article 14 of the RAO refers to "buying, selling, subscribing for or underwriting securities or contractually based investments". Article 3 of the RAO defines "buying" an investment to include "acquiring for valuable consideration" and "selling" an investment to include "disposing of an investment for valuable consideration", with "disposing" given an expansive definition. It is therefore not entirely clear whether (given the breadth of the prohibition on dealing in investments as principal) ring-fenced banks may, for example, acquire or dispose of investments pursuant to an order of the court; or make charitable donations or other gifts of securities. It is also unclear whether a ring-fenced bank may enter into a principal trade in securities in circumstances where an agency trade in securities on behalf of a client has failed and the ring-fenced bank inadvertently becomes the counterparty to the trade, as is common practice (indeed a requirement of

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[12] **Article 17: Acceptance of instruments creating or acknowledging indebtedness**

> (1) A person does not carry on an activity of the kind specified by article 14 by accepting an instrument creating or acknowledging indebtedness in respect of any loan, credit, guarantee or other similar financial accommodation or assurance which he has made, granted, or provided.
>
> (2) The reference in paragraph (1) to a person accepting an instrument includes a reference to a person becoming a party to an instrument otherwise than as a debtor or a surety.

Article 18A: Dealing by a company in its own shares

> (1) A company does not carry on an activity of the kind specified by article 14 by purchasing its own shares where section 724 of the Companies Act 2006 (Treasury shares) applies to the shares purchased.
>
> (2) A company does not carry on an activity of the kind specified by article 14 by dealing in its own shares held as treasury shares, in accordance with section 727 (Treasury shares: disposal) or 729 (Treasury shares: cancellation) of that Act.
>
> (3) In this article "shares held as treasury shares" has the same meaning as in that Act.

some market infrastructure) in the case of settlement failures. This uncertainty has had the practical impact of casting doubt on the ability of ring-fenced banks to provide execution services in securities to their customers.

4.4. Section 142D of FSMA provides that HM Treasury may by order provide for an activity to be an excluded activity, either generally or when carried on in circumstances specified in the order. Article 5(1) of the EAPO specifies that dealing in commodities is an excluded activity, subject to certain exceptions in Articles 6, 8, 9, 10, 11 and 12. Article 5(2) provides that a ring-fenced body may nevertheless deal in commodities for its own use or consumption or for use or consumption by a subsidiary undertaking.

4.5. Article 4 provides that dealing in investments as principal is not an excluded activity where it is carried on in accordance with any of Articles 6 to 12 of the EAPO. Articles 6(1) and (2) of the EAPO permit a ring-fenced body to enter into a transaction with another person if the sole or main purpose for which the ring-fenced body entered into the transaction, either by itself or in combination with other transactions, is that of limiting the extent to which the ring-fenced body or certain other persons will be adversely affected by certain specified factors. Please see section 7 below for a discussion of this exemption.

4.6. The specified factors include "default risk," which is defined in Article 1(4) of the EAPO. While this would, for example, be expected to encompass entering into a credit default swap, it is less clear whether it would include simply selling an investment where the ring-fenced body is concerned that the issuer or counterparty may default. Indeed, given the use of the wording "entering into a transaction" in Article 6(1), it is not clear whether, for example, unwinding a hedging derivative would be permitted in circumstances where the required purpose is present—i.e., to limit potential adverse impact of the specified factors. Given that such an unwind would likely involve exchange of consideration, it may be possible to regard this as "selling," as defined in the RAO, which includes disposing for valuable consideration and additionally includes surrendering, assigning, or converting rights under an investment consisting of rights under a contract. Ring-fenced bodies that owned minority shareholdings in companies prior to the ring-fencing regime taking effect on 1 January 2019 are prohibited from selling those shareholdings unless an exemption applies under the EAPO. Article 6 of the EAPO provides for the acquisition and disposal of various shareholdings. In some cases, it is therefore simply unclear how a ring-fenced bank may lawfully dispose of such an asset. There is a transitional provision in Article 21 of the EAPO allowing the disposal of investments created or acquired before 1 January 2019 but only where "the period remaining until the investment matures is less than two

years at 1st January 2019", which was of no assistance for holdings of ordinary shares (which are perpetual) and, in any event, is of no assistance going forward, possibly leaving ring-fenced banks with trapped assets which either are no longer required or are minority shareholdings in market infrastructure firms that were originally acquired in connection with the bank's membership of an exchange or payment system. Although disposals of "participating interests" are permitted by Article 6(5) of the EAPO, he definition of a participating interest will not always be met in relevant circumstances.[13]

4.7. Article 6(4)(c) of the EAPO permits a ring-fenced bank to acquire a debenture from the issuer thereof where the debenture "relates to" any loan, credit, guarantee or other financial accommodation made to the issuer or an affiliate by the ring-fenced bank or one of its subsidiaries. It is unclear what the intended nature of the relationship is between the debenture and the financial accommodation. Additionally, market participants have understood informally from discussions with HM Treasury that the purpose of this sub-paragraph (c) was to permit ring-fenced banks to acquire debt instruments and hold them to maturity, which does not appear to be the result achieved by the drafting.

4.8. The regime has created considerable uncertainty and complexity in the structuring of securitisation and covered bond arrangements involving assets originated by ring-fenced banks. To give an example, while dealing in investments in principal is an excluded activity, Article 7 of the EAPO permits ring-fenced banks to acquire debt securities issued by its sponsored structured finance vehicles (as defined in Article 3(20) of the EAPO). There are, however, very limited circumstances in which such a ring-fenced bank may subsequently dispose of these securities. It seems anomalous that the regime allows acquisitions but generally prohibits disposals of such investments.

4.9. Furthermore, Article 3(2) of the EAPO defines a "sponsored structured finance vehicle" of a ring-fenced bank as a structured finance vehicle whose only assets consist of those that fall within a specified list of assets set out in sub-paragraphs (a) to (h) of that Article. This list includes, in sub-paragraph (b), assets originated by the ring-fenced bank in question or its subsidiary undertakings. This wording does not include assets originated by another ring-fenced bank within the same group which is not a subsidiary (for example, a sister company). Consequently, a traditional or synthetic securitisation in which one ring-fenced bank participates cannot include assets originated by another ring-fenced bank in the group (unless so originated within the specified time limits in paragraph (b)(iv)). This may be an unintended consequence of the drafting as it is unclear why a

[13] See section 421A FSMA.

ring-fenced bank is permitted to have exposures to assets originated by other members of its group which are not themselves ring-fenced banks (as long as they are subsidiaries) but is prevented from being exposed to a pool of assets originated by another ring-fenced bank in its own group that is not a subsidiary. In addition, it is not clear why the list of assets of sponsored structured finance vehicles in Article 3(2) omits cash forming the proceeds of the issue of debt securities. This omission would, on the face of it, appear to exclude from the definition of a sponsored structured finance vehicle ordinary securitisation debt issuance vehicles, regardless of the nature of any assets they own. This has created legal uncertainty about what a sponsored structured finance vehicle is intended to be.

4.10. Finally, Article 9 of the EAPO permits certain derivatives contracts to be entered into with "account holders" of the ring-fenced body. It is not clear what the intended interpretation of "account holder" should be: i.e., whether it means customers who have deposit accounts or whether it can be construed more widely to include any customer on-boarded by the firm. In principle, it would not seem to offend against the policy purposes of ring-fencing to allow a ring-fenced bank to provide a hedging instrument to a borrower client, regardless of whether the borrower client has a deposit account with the ring-fenced bank.

Solutions and mitigants

4.11. Regarding the uncertainties identified around the application of Article 20 of the RAO, FMLC recommends clarificatory wording and/or regulatory guidance on the interpretation of that Article. This could be achieved in the context of a general updating of the RAO. A clarification of Article 6(4)(b) of the EAPO is needed to remove uncertainty as Article 6(4)(b) allows a ring-fenced body to deal as principal in debentures or instruments giving an entitlement to shares or debentures issued by it or its subsidiary, but it does not seem to say that a ring-fenced body may issue its own shares. The FMLC also recommends amending Article 6(1) to refer additionally to "the disposal or unwinding of an existing investment" to provide greater certainty. In this context, a questionnaire could be provided to banks to identify the nature of holdings in respect of which uncertainty still exists. A clarification of Article 6(4)(c) of the EAPO is also needed to remove uncertainty as to its scope and purpose. The FMLC suggests that providing regulatory guidance would reduce the need for constant revision of the EAPO. This could possibly be done by order of HM Treasury under Section 142D (2) of FSMA, which requires the affirmative procedure, and Section 142F.

4.12. Additionally, the amendment of the RAO post-Brexit has removed central banks of EEA states from the list of persons in Article 6 RAO, meaning that sums paid by such central banks are no longer excluded from the definition of "deposit". This has had a consequential impact on the scope of the CAO. A general updating of the RAO could usefully assess the impact of the amended RAO on the CAO and EAPO.

4.13. The FMLC also recommends amending the EAPO to allow guidance to be given by the PRA on what amounts to default risk. Additional clarification of the meaning and interpretation of "account holder" under Article 9 of the EAPO would also be useful.

4.14. In relation to the possibly unintended consequence in Article 3(2), Article 3(2)(iii) could be expanded to include other ring-fenced bodies within the same group or other undertakings within the same group, provided always that the assets concerned are assets which the ring-fenced body itself could hold. In addition, Article 3(2) should be amended to incorporate a reference to the cash proceeds of an issue of debt securities, and this reference could usefully be extended to include any receivable related to such cash proceeds so as to capture any loan of that cash that a securitisation issuer makes.

5. THE PROHIBITION ON "FINANCIAL INSTITUTION EXPOSURES"

Background

5.1. Under Article 14(1) of the EAPO, a ring-fenced body is prohibited from incurring a 'financial institution exposure' unless at least one of the exemptions set out in Articles 14(2) to (6) or in Articles 15 to 19B of the EAPO applies.[14] The purpose of this prohibition is, broadly, to limit the extent to which ring-fenced bodies are exposed to risk taking and failure in financial institutions that are not ring-fenced bodies. This is consistent with comments in the Final Report of the Independent Commission on Banking ("**ICB**"), published in 2011, which proposed a principle that, subject to exceptions, ring-fenced banks should be prohibited from providing services that directly increase the exposure of the ring-fenced bank to global financial markets or result in an exposure to a non-ring-fenced bank or a non-bank financial organisation.[15]

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[14] SI 2014/2080.

[15] Independent Commission on Banking, *Final Report*, (September 2011), available at https://webarchive.nationalarchives.gov.uk/ukgwa/20111108115104/http:/www.hm-treasury.gov.uk/d/ICB-Final-Report.pdf (paragraph 3.39).

5.2. A "financial institution exposure" is defined for this purpose in Article 1(4) of the EAPO as an 'exposure' to a 'relevant financial institution' or an exposure to securities or other financial instruments issued by a relevant financial institution, but does not include an exposure where the sole or main purpose for which the ring-fenced body incurs the exposure to the relevant financial institution is to provide for:

i. the safeguarding and administration of assets of the ring-fenced body by that financial institution; or
ii. client money or client assets to be held for the ring-fenced body by that relevant financial institution.

There is no reference in the EAPO to the quantum or value of a financial institution exposure. A ring-fenced body is prohibited from incurring any such exposure, however small, unless an exemption applies.[16]

5.3. A "relevant financial institution" is defined in Article 2 of the EAPO by reference to a wide range of firms and other entities operating in the financial sector.

Issues of legal uncertainty

Exposures

5.4. An "exposure" is defined in the EAPO by reference to the definition of that term in Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms ("**Capital Requirements Regulation**" or "**CRR**"), as that Regulation now forms party of domestic law pursuant to the European Union (Withdrawal) Act 2018, and as amended by the Capital Requirements (Amendment) (EU Exit) Regulations 2018 (the "**U.K. CRR**"), but 'without applying the risk weights or degrees of risk set out

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In the context of exposures, the Final Report also stated that '*The purpose of the distinction between financial and non-financial companies is to reduce the exposure of ring-fenced banks to failures elsewhere in the financial system*' (paragraph 3.46).

[16] An 'exposure' is defined in Article 1(4) to mean:

i. an asset referred to in Part Three, Title II, Chapter 2 of the Capital Requirements Regulation (as that Regulation now forms part of domestic law pursuant to the European Union (Withdrawal) Act 2018 (as amended), and as amended by regulations made under that Act) (the U.K. CRR Regulation 575/2013/EU); or

ii. an off-balance sheet item listed in Annex I to the U.K. CRR,

but 'without applying the risk weights or degrees of risk set out in' the U.K. CRR.

in' the U.K. CRR. The definition concerned is that used in the U.K. CRR to determine when a bank or (where applicable) an investment firm is required to hold capital against a credit exposure. Exposures are classified as 'assets' (such as loans) or off-balance sheet items (including certain contingent liabilities) for this purpose. What these items all have in common is that on the default of a counterparty the relevant firm that has the exposure would suffer a loss, hence the requirement to hold capital against that eventuality under the U.K. CRR. Article 111 of the U.K. CRR states that the exposure value of an asset item is its accounting value after specific adjustments in accordance with Articles 34, 36(1), 105 and 110 of the U.K. CRR. The exposure value of an off-balance sheet item listed in Annex I to the U.K. CRR is set by reference to a prescribed percentage of its nominal value after specific adjustments under the U.K. CRR, the percentages ranging from 0% to 100%.

5.5. It is not clear whether there would be an exposure if the exposure would be valued at zero under the U.K. CRR. It is also unclear whether the provisions of the U.K. CRR on valuation and adjustments should be taken into account when determining whether an exposure would be incurred for the purposes of the EAPO. A closely related point is that it is not clear whether steps taken to mitigate an exposure should be taken into account for this purpose. In general, where a U.K. bank takes security over assets in order to mitigate credit risk to a counterparty and the security arrangement amounts to eligible credit risk mitigation under the U.K. CRR, for the purposes of the U.K. CRR the bank may treat its exposure as being to the secured assets rather than to the counterparty. For example, if a ring-fenced bank incurs an exposure to a non-ring-fenced bank outside its group but secures that exposure fully by taking security over highly rated government bonds that benefit from a 0% risk weighting under the U.K. CRR, it is not clear whether the ring-fenced bank will have incurred a prohibited exposure to the non-ring-fenced bank for the purposes of the EAPO. Market practice on interpretation of the EAPO is to ignore the security (and other credit risk mitigation techniques) in this scenario so as to give effect to the underlying purpose of the ring-fencing regime, which is to limit and control the extent to which ring-fenced banks deal with and are exposed in a more general sense to failure of other financial institutions. This approach is supported by the definition of 'exposure' in the EAPO, which, as noted above, requires that the question of whether an exposure would be incurred takes place 'without applying the risk weights or degrees of risk set out in' the U.K. CRR, but it is not clear exactly what this means, not least because it does not clearly state that the use of credit risk mitigation techniques (e.g. security) should be ignored for this purpose.

5.6. It is not clear in all circumstances when an exposure would be "incurred." Where a ring-fenced bank enters a transaction under which it becomes exposed to a relevant financial institution immediately, then it is clear that the ring-fenced bank would incur the exposure at that time. If, however, the ring-fenced bank enters into a transaction which does not result in an immediate exposure but could result in an exposure at some time in the future, perhaps only in certain circumstances or upon the satisfaction of certain conditions, it remains uncertain when the exposure can be said to have been "incurred" for the purposes of the EAPO. This point is linked to some extent with the point in paragraph 5.5 above in circumstances where a contingent exposure is valued at zero for the purposes of the U.K. CRR. More fundamental, perhaps, is the question of what 'incur' means and whether this requires an act or omission on the part of the ring-fenced bank. This is addressed further in paragraph 5.9 below.

5.7. It follows from the points above that it is not clear whether a ring-fenced bank may invest in secured debt issued by a relevant financial institution. As noted above, the definition of a financial institution exposure in the EAPO includes an exposure to securities or other financial instruments issued by a relevant financial institution. If these are debt securities and are secured on assets unrelated to the credit risk of the relevant financial institution, the same point as raised in paragraph 5.5 arises and it is not clear that the ring-fenced bank would incur an exposure to the relevant financial institution or to the relevant secured assets by acquiring the securities.

5.8. The treatment of financial institution exposures that existed on 1 January 2019, when the relevant provisions of the EAPO came into force, remains unclear. It is also unclear whether a ring-fenced bank that had incurred an exposure before that date would be in breach of the EAPO if that exposure has subsequently increased in value. Article 21 of the EAPO states that a ring-fenced body does not carry on an excluded activity or contravene a prohibition imposed by the EAPO by holding or selling any investments on or after 1 January 2019 provided that: (i) the investment in question was created or acquired by the ring-fenced body before 1 January 2019; and (ii) the period remaining until the investment matures is less than two years on 1 January 2019. This provision is, however, of limited assistance where a ring-fenced body incurred a financial institution exposure before 1 January 2019.

5.9. The treatment of exposures to relevant financial institutions that are incurred in connection with the enforcement by a ring-fenced bank of security is unclear. A ring-fenced bank might take security over assets that carry exposures to relevant financial institutions, potentially without knowing that this is the case. For example, a charge

given in connection with an all-moneys debenture may extend to a portfolio of securities issued by relevant financial institutions held by the borrower or may simply extend to deposits held with non-ring-fenced banks, either of which would involve exposures to the relevant financial institutions concerned. Ring-fenced banks have tended to conclude that taking and enforcing security over such assets is permitted under the exemption in Articles 14(2) and 14(3)(d) of the EAPO, which permits a ring-fenced bank to incur a financial institution exposure if the sole or main purpose of the transaction giving rise to the exposure (by itself or in combination with other transactions) is to limit the extent to which, inter alia, the ring-fenced bank will be adversely affected by default risk. 'Default risk' is defined for this purpose in Article 1(4) of the EAPO. It is clear that the principal purpose of this exemption was to permit credit default swaps and other protection provided by relevant financial institutions from the prohibition on incurring financial institution exposures and it is not completely clear whether the exemption applies in the (arguably more straightforward) case of a ring-fenced bank taking security over assets of the kind mentioned above. It is also unclear whether, having enforced its security and taken possession of secured assets that include assets carrying financial institution exposures, a ring-fenced bank may permit those exposures to increase or to be substituted by other exposures to the same or another relevant financial institution. Either of these developments may follow the default of the borrower but it is no clear that the 'default risk' exemption would apply at that stage because the default will then already have occurred.

Definition of "relevant financial institutions"

5.10. As noted above, 'relevant financial institution' is defined in Article 2 of the EAPO by reference to a wide range of financial institutions. The FMLC notes that, while the definition has some clear elements, in some respects it embeds significant uncertainty. The legal uncertainties which arise include the following:

i. Alternative Investment Funds: The list of relevant financial institutions includes alternative investment funds ("**AIFs**"), which are in turn defined by reference to the definition of that expression in regulation 3 of the Alternative Investment Managers Regulations 2013.[17] This definition itself raises many points of uncertainty, beyond the scope of this paper, but by including AIFs on the list of relevant financial institutions in the EAPO those uncertainties are imported into the question of whether a ring-fenced bank may incur an exposure to a vehicle with this potentially

[17] SI 2013/1773

uncertain characterisation. Perhaps more fundamentally, since AIFs include many unregulated and unregistered vehicles, it may not be possible for a ring-fenced bank to ascertain whether such a vehicle is an AIF. There is a corresponding uncertainty about managers of AIFs ("**AIFMs**"), which are also relevant financial institutions for this purpose. If there is legal uncertainty about whether a vehicle is an AIF, then there will also be uncertainty whether an entity managing that vehicle is an AIFM.

ii. Financial holding companies and mixed financial holding companies: Whether a holding company falls into these categories depends on certain criteria and on the exercise of judgment about the sectors or assets in which the preponderance of the relevant group's activities lie. This is sometimes resolved by determinations made privately by relevant regulators. There is no register or other public determination of whether a holding company is a 'financial holding company,' giving rise to uncertainty for a ring-fenced bank about whether it may incur an exposure to a holding company where its status is uncertain.

iii. Certain investment firms: Relevant financial institutions include "investment firms," which are not defined in the EAPO but are defined in FSMA by reference to the definition of "investment firm" in paragraph 2.1A of U.K. MiFID II. Article 2(3)(f) of the EAPO excludes from the definition of relevant financial institution 'investment firms which are not authorised to carry on by way of business (in the United Kingdom or the EEA) the activities specified by either Article 14 (dealing in investments as principal) or Article 21 (dealing in investments as agent) of the RAO. This is uncertain in relation to investment firms authorised in the European Economic Area ("**EEA**") because EEA Member States generally do not define regulated activities in the same way as those in Articles 14 and 21 of the RAO. It may not be straightforward for a ring-fenced bank to determine whether an EEA investment firm is, in effect, authorised to carry on activities that correspond to those RAO activities.

iv. Change in status of counterparties: Article 19B of the EAPO addresses the situation where a ring-fenced bank incurs a financial institution exposure under a transaction as a result of the counterparty to a transaction becoming a relevant financial institution at any time after the transaction was entered into. In that situation, the ring-fenced bank is permitted to retain the exposure for up to 12 months from the date on which the counterparty became a relevant financial institution provided, at the time the transaction was entered into, the ring-fenced bank did not know, and

could not reasonably be expected to have known, that the counterparty would become a relevant financial institution. This provision raises the question again of when a financial institution exposure is 'incurred' and whether, for the purposes of the EAPO, a ring-fenced bank can 'incur' such an exposure without any act or omission on its part. Article 19B operates on the premise that it is possible for a ring-fenced bank to incur a financial institution exposure solely as a result of a change to the counterparty's status.

Exemptions

5.11. Articles 14 to 19B of the EAPO contain exemptions from the prohibition on ring-fenced banks incurring financial institution exposures. Article 14(2) of the EAPO allows a ring-fenced bank to incur a financial institution exposure if the sole or main purpose of the transaction giving rise to the exposure (by itself or in combination with other transactions) is to limit the extent to which the ring-fenced bank and/or certain other entities specified in Article 14(2) will be adversely affected by any of the factors specified in Article 14(3). While the ability to take into account a number of transactions operating in combination appears to introduce flexibility into this exemption, it is not clear how far the concept of transactions "in combination" can be taken in circumstances where a new transaction is entered into with the purpose, when taken in combination with a prior transaction, to reduce a risk referred to in Article 14(3). It is unclear whether, in that example the prior transaction must also have been entered into with that purpose or whether the purpose of the subsequent transaction governs that of the combination. It would be sensible if Article 14(2) made clearer that it applies regardless of this point. This could be done by inserting the words ", whenever entered into" immediately after the words "by itself or in combination with other transactions" in the parentheses in Article 14(2).

5.12. Article 14(3A) of the EAPO permits a ring-fenced bank to incur a financial institution exposure

> if the purpose of the transaction giving rise to the exposure is to allow the bank to hold liquid assets in order to meet the general requirement set out in Article 412 of the [U.K. CRR] and further specified in delegated acts…[18]

[18] Article 412 of the U.K. CRR establishes the liquidity coverage requirement for banks under which banks are required to hold liquid assets the aggregate value of which covers their liquidity outflows less the liquidity inflows under stressed conditions. This requirement is designed to ensure that banks maintain levels of liquidity buffers which are adequate to face any possible imbalance between liquidity inflows and outflows under gravely stressed conditions over a period of 30 days.

Liquidity management in banks is often a sophisticated and interwoven set of activities and it is doubtful whether the words "to allow the bank to hold" provides the legal clarity that bank treasury functions require to apply this exemption with confidence. For example, it is often necessary or desirable to hedge changes in prices of debt securities that form part of the liquidity buffers of banks. Such hedging may well not fall within the list of risks in Article 14(3) and is arguably not directly geared towards allowing the bank to hold liquid assets: it may simply protect the value of the liquid assets that the bank holds already.[19] More fundamentally, banks need to be able to sell liquid assets, and to incur financial institution exposures (e.g. to purchasers of those assets) when doing so, as well as to hold them, and it is not clear whether selling liquid assets can be said to be "to allow the bank to hold" them.

5.13. Article 14(4) of the EAPO contains an exemption from the prohibition on ring-fenced banks incurring financial institution exposures in connection with intra-group transactions, subject to a number of conditions:

i. The first condition is that the exposure concerned is not prohibited under rules made by the FCA or the PRA under FSMA. On a literal reading, this refers to any rules made by the FCA or the PRA under FSMA, regardless of whether those rules relate in any way to the ring-fencing regime, but it is not clear whether that is the intended effect of this condition.

ii. The second condition depends on the circumstances and includes that the exposure arises as a result of "a commercial transaction conducted on arm's length terms".[20] There is no definition of "commercial transaction" for this purpose, even though many intra-group transactions are, regardless of their terms, not obviously "commercial" in nature because they do not involve an external customer or counterparty. The concept of "arm's length terms" has typically engaged a number of factors, including pricing and the terms of the transaction, but if the correct comparator is a transaction with a third party that is not a member of the same group as the ring-fenced body, then this creates a challenge because many intra-group transactions have no such comparators in the market. It is unclear whether this condition seeks to impose a different standard to that which applies under tax

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[19] Article 18(b) permits a ring-fenced bank to incur a financial institution exposure for the purposes of managing the ring-fenced bank's liquidity using repo transactions but does not refer to other transactions that banks commonly employ to manage their liquidity.

[20] Article 14(4)(b)(i) of the EAPO

rules in relation to transfer pricing. It seems, however, that in practice ring-fenced banks have used that standard in seeking to comply with Article 14(4) and practical difficulties may arise if some other standards were required. It would be helpful to clarify this.

iii. An alternative second condition is that the relevant financial institution enters into any guarantee, bond, contract of indemnity or other security, or becomes responsible for any pension liability of the ring-fenced bank.[21] This reinforces the uncertainty noted in paragraph 5.6 above as to the time when a ring-fenced bank would be considered to have "incurred" a financial institution exposure. Where a member of a ring-fenced bank's group gives a guarantee from which the ring-fenced bank may benefit then that benefit, and hence any exposure that the ring-fenced bank would have to the guarantor, would be contingent at best. A question would arise as to when any exposure would be "incurred."

5.14. Article 14(5) of the EAPO provides that a ring-fenced bank may incur a financial institution exposure in the course of buying, selling or subscribing for investments for the purposes of a transaction falling within of Article 14(2) (i.e., the risk management exemption referred to above). The purpose of this exemption is, however, unclear. If it was intended to permit a ring-fenced bank to incur financial institution exposures when acquiring collateral for permitted hedging transactions, it is not clear why the wording of this exemption does not track that of Article 6(3)(b), which is a clear exemption for acquiring collateral for permitted hedging transactions in the context of the excluded activity of dealing in investments as principal. The drafting of Article 14(5) would also seem to have the odd effect of facilitating the acquisition of collateral for permitted hedges only if such hedges were themselves with relevant financial institutions (as other hedges would not fall within Article 14(2)). If, on the other hand, the exemption in Article 14(5) is not intended to cover collateral, its only obvious meaning would be to permit a ring-fenced bank to incur of a financial institution exposure in the buying of investments etc. that themselves constitute the permitted hedge, but that would be redundant as it is already permitted by Article 14(2). In addition, the Ring-Fenced Bodies chapter of the PRA Rulebook clearly groups together the exemptions under Article 6(3)(b) and Article 14(5), defining them as the "collateral exception". As a consequence, it seems clear that the intention (at least in the view of the PRA) is that Article 14(5) be as permissive as

[21] Article 14(4)(b)(iii))

Article 6(3)(b) in providing for the collateral for transactions entered into on the basis of the hedging exemption.

5.15. Article 14(6) of the EAPO allows a ring-fenced bank to incur a financial institution exposure where the exposure concerned is a "payment exposure" and the ring-fenced body has complied with any rules made or requirements imposed by the FCA or the PRA under FSMA in relation to payment exposures. A "payment exposure" is defined in Article 1(4) and includes exposure incurred "in the ordinary course of settlement" of foreign exchange transactions and transactions for the purchase or sale of securities. It is not clear what "ordinary course" means in this context and whether, for example, a delay in settlement that does not result from any act or omission of the ring-fenced bank should be treated as "ordinary course" for this purpose. There is no such "ordinary course" requirement in relation to an exposure arising from money transmission, which is also included in the definition of "payment exposure."

5.16. Article 19 of the EAPO contains exemptions relating to a number of "ancillary" financial institution exposures. Ring-fenced bodies are permitted to incur financial institution exposures where they arise in consequence of the provision by the ring-fenced bank to the relevant financial institution of "operational services".[22] It is not clear what "operational" means in this context, particularly in light of other services referred to in article 19(2)(b), but not termed "operational", where a ring-fenced bank is permitted to incur a financial institutions exposure when it provides them. These services include "services as a trustee or agent in connection with a syndicated loan to an undertaking which is not a relevant financial institution" and "consultative services."[23] Further, ring-fenced bodies are permitted to incur financial institution exposures where they arise in consequence of the provision of services by a relevant financial institution which are "ancillary to or facilitate" certain specified arrangements (article 19(2)(c)). The arrangements specified are very broad and include, for example, "the divestment or acquisition by the ring-fenced body of one or more of its subsidiaries or other assets" and "the continuing operation of a business, entity or assets which have been acquired by the ring-fenced body." There is uncertainty about what, exactly, is ancillary to or facilitates such an arrangement and whether, for example, a bank guarantee that is desirable but is not a necessary part of an

[22] Article 19(2)(b)(i)) of the EAPO

[23] Article 19(2)(b)(ii)) and (article 19(2)(b)(iv)

arrangement would fall within these exemptions.[24] In the context of acquisitions, it is not clear how this exemption should interact with the separate exemption in Article 19(4) of the EAPO, which relates to exposures arising "in consequence of guarantees, warranties, indemnities or covenants given to the ring-fenced body by a relevant financial institution as part of a permitted acquisition or disposal".

5.17. Article 19(5)(a) of the EAPO permits a ring-fenced bank to incur a financial institution exposure where the exposure arises in consequence "of a breach of duty owed by the relevant financial institution to the ring-fenced body". This raises the question, also raised previously in this Report, of when a financial institution exposure is incurred for the purposes of the ring-fencing regime. In the context of a warranty given by a relevant financial institution in an agreement under which that financial institution agrees to sell a business to a ring-fenced bank, uncertainties arise about whether the bank incurs an exposure to the financial institution when the warranty is given or only when it makes a claim under the warranty. While this exemption would suggest the latter, other exemptions, such as the ancillary exemptions discussed above, would suggest otherwise.

5.18. Finally, Article 19(7) of the EAPO permits a ring-fenced bank to incur a financial institution exposure "that arises where the ring-fenced body is acting as trustee for or on behalf of any individual or charity". This suggests that it would not be permitted for a ring-fenced bank to incur such an exposure when acting as trustee for or on behalf of a body corporate that is not a charity. It is, however, not clear what this exemption seeks to achieve because it would not normally be the case that a trustee would incur an 'exposure' within the meaning used in the EAPO. For example, a trustee that holds securities issued by a relevant financial institution on behalf of a beneficiary of any kind is generally not exposed to the risk of default by the issuer of those securities.

Financing of infrastructure projects

5.19. Entities in infrastructure financial projects and fund structures may participate in a broad range of activities beyond financing, particularly when it comes to acquiring, owning, and manging infrastructure. It is unclear whether such entities could be treated as "infrastructure special purpose vehicles" ("**ISPV**s") which are defined in Article 19A of the EAPO as entities the only business of which (apart from incidental activities) is financing the acquisition, design, construction, conversion, improvement, operation and repair of infrastructure within the United Kingdom or the EEA. Article 19A permits a

[24] If indeed a bank guarantee gives rise to such an exposure at all at the time when it is given. See comments on this point in paragraph 5.8.

ring-fenced bank to incur a financial institution exposure where the exposure is to an ISPV or arises from financial assistance given by the ring-fenced bank to an ISPV. However, firms involved in infrastructure development are often not special purpose vehicles given their activities, and they may fall within the definition of "relevant financial institution" without being ISPVs (see paragraph 5.10 above). The exemption in Article 19A is therefore of limited utility. Moreover, the reference in the definition of an ISPV to 'incidental activities' carries legal uncertainty, as does the use of the word 'entity': does that include, for example, trust and fund structures? Furthermore, infrastructure firms often own and manage infrastructure assets as well as financing them, and in any event the financing activity to which the existing definition of an ISPV refers may inevitably result in ownership of some or all of the assets in question if the relevant borrower defaults. The omission from the definition of an ISPV of a reference to ownership and management of the assets in question creates uncertainty about whether a ring-fenced bank may incur a financial institution exposure to an ISPV if it is unclear whether the ISPV will remain within the definition of an ISPV in the EAPO in circumstances where it acquires ownership of, or manages, infrastructure assets.

Solutions and mitigants

Financial institution exposures

5.20. Prior to addressing the many legal uncertainties arising from the prohibition on financial institution exposures and related exemptions that are highlighted above, it would be sensible to address the two pervasive areas of legal uncertainty to which the prohibition gives rise, namely what an exposure is (including how it is to be valued and whether credit risk mitigation reducing the value of an exposure may be taken into account); and when an exposure is deemed to have been incurred for the purposes of the EAPO (particularly where it is subject to a contingency). These uncertainties have created inconvenience, expense, and business uncertainty in many transactions in which ring-fenced banks and their contractual counterparties are involved.

5.21. Although this may not ameliorate the fundamental problems with financial institution exposures and how and when they may arise for the purposes of the EAPO, it may be useful to add an exemption to Article 14 of EAPO by way of a new clause (7) which allows a ring-fenced body to incur a financial institution exposure if the size of the exposure is below a fixed monetary threshold. While determining the exact amount of the threshold and how it is calculated would require further discussion and consultation among HM Treasury, the PRA and market participants, it is hoped that the introduction

of a monetary threshold may allow ring-fenced banks to deal with SMEs that are relevant financial institutions. This would reduce the uncertainty faced both by ring-fenced banks, which may be required to off-board such customers as a result of the prohibition on incurring financial institution exposures to them, and by the customers themselves which may face difficulties if a ring-fenced bank concludes that it is not permitted to serve them.

5.22. Further, as analysed in paragraph 5.14, it seems clear that, at the very least, the PRA's intention is that the provision in Article 14(5), allowing a ring-fenced bank to incur an financial institution exposure in the course of buying, selling or subscribing for investments for the purposes of a transaction falling within the risk management exemption in Article 14(2), be as permissive as the ability of ring-fenced banks, provided in Article 6(3)(b), to deal in investments for the purposes of providing collateral for transactions entered into on the basis of the hedging exemption. The EAPO should be amended, for example as set out below, to reflect this explicitly (changes in bold):

Article 14 of the EAPO:

(5) A ring-fenced body may incur a financial institution exposure in the course of buying, ~~**selling**~~ or subscribing for investments ~~**for the purposes of**~~ **to provide collateral in connection with** a transaction falling within paragraph (2) **or within paragraph (1) of Article 6, or selling investments acquired for that purpose**.

Financing of infrastructure projects

5.23. In order to address the uncertainty noted above in relation to ISPVs, the FMLC suggests amending Article 19A of EAPO in the following manner (changes in bold):

(2) For the purposes of this article—

(a) "financial assistance" means—

(i) loans **or finance lease arrangements**,

(ii) guarantees or indemnities, or

(iii) the purchase of bonds or notes.

(b) "infrastructure special purpose vehicle" means an entity the ~~**only**~~ **main** business of which (apart from incidental activities) is financing the acquisition, design, construction, conversion, improvement, operation and

repair of infrastructure within the U.K. or the EEA **and acquiring, owning, and managing infrastructure as part of such financing arrangements, where, for these purposes, an entity shall include a segregated cell of a legal entity where, under the laws of its constitution, the legal entity is split into segregated cells such that creditors with claims on assets in one cell may not claim against the value of assets held in another cell.**

6. LIQUIDITY MANAGEMENT FOR RING-FENCED BANKS

Background

6.1. A key principle of the ring-fencing provisions introduced under Part 9B of the FSMA was to prevent retail bank entities from carrying out activities which might introduce undue risk to their balance sheets, such as proprietary trading.[25] This was achieved principally by prohibiting ring-fenced banks from carrying on the regulated activity of "dealing in investments as principal", pursuant to Article 4 of the EAPO and by prohibiting them from incurring exposures to a wide range of other financial institutions, pursuant to Article 14 of the EAPO.[26]

6.2. Although proprietary trading in regulated financial instruments will clearly fall within the scope of the "dealing in investments as principal" activity, a blanket prohibition would give rise to several difficulties, since the activity is also invoked by day-to-day banking operations such as the provision and return of collateral, repurchase transactions and the issuance of shares and bonds. As a result, the 2011 ICB Report proposed an exception for certain ancillary activities, which would be necessary for ring-fenced banks to conduct in order to provide their services efficiently.[27]

6.3. The need for ring-fenced banks to manage liquidity was first developed as an exception to the prohibition on proprietary trading in the ICB Report.[28] This was regarded as necessary to facilitate the prudent management of risks that arise from intermediation

[25] See *ICB Final Report, supra* n. 16

[26] Article 14 of the RAO

[27] See *ICB Final Report, supra* n. 16

[28] Ibid, paras 3.54-3.55.

between savers and borrowers.[29] Any bank will need to manage its liquidity risk appropriately, since deposits are repayable and actual requests for repayment (including spending) of deposits by account holders fluctuate over time. Banks need to invest the cash that they receive from depositors to generate an income from their banking activities and hence to be able to pay interest to savers. Concurrently, banks also need to keep a certain amount of assets which are readily realisable as cash, in order to cope with any variations or surges in demand for repayments by depositors. Banks will typically manage their liquidity by investing the cash that they receive from depositors in a range of financial loans or instruments with differing maturity dates and diverse but generally conservative risk profiles, with both longer dated and shorter dated assets. Shorter dated instruments will typically be in the form of overnight or short-dated sale and repurchase transactions (repos), where cash held by a ring-fenced bank is exchanged for low-risk government bonds, on terms that the transaction be unwound after a period of time. In addition, banks will invest some deposits directly in highly liquid, readily realisable, low-risk assets such as government bonds by purchasing these outright. The amount of liquid assets that a bank needs from time to time will vary and can be managed realistically only by investing in and out of shorter and more liquid versus longer dated and less liquid investments. These activities necessarily involve "dealing in investments as principal."

Issues of legal uncertainty

6.4. Under Article 6(1) of the EAPO, ring-fenced banks are permitted to deal in investments as principal provided the "sole or main purpose" of the transaction is to limit the extent to which "liquidity risk" adversely affects the ring-fenced bank. There are certain legal uncertainties and ambiguities in relation to this provision (some of which are addressed in sections 4 and 5 of this Report), which have had practical consequences for some ring-fenced banks' liquidity management operations. These arise because the scope of the "liquidity risk" exemption is difficult to apply in practice and, if narrow interpretations are adopted, the meaning becomes potentially constraining.

"Sole or main purpose" test

6.5. Under Article 6(1) of the EAPO, in order for "liquidity management" to be permitted, the "sole or main purpose" of the transaction must be to limit the extent to which a range of factors, including liquidity risk, adversely affect the ring-fenced bank. It is not always clear whether a transaction would or would not involve "limiting liquidity risk" for these

[29] Ibid, paras 3.50 and 3.54-3.55.

purposes. The effective management of a portfolio of high-quality liquid assets necessarily involves commercial considerations that go beyond the liquidity of investments. In particular, ring-fenced banks will need to look to other factors when operating a liquidity management programme, such as market prices, yield, coupon (interest payable), credit risk (including credit rating) and tenor of particular investments. Whilst the overall liquidity management of a portfolio will have the management of liquidity (and other factors listed under Article 6(2) of the EAPO) as its "sole or main purpose", individual transactions within that portfolio may not, and the balance of investments in a portfolio will vary not merely with respect to liquidity considerations. For example, a bank may find that it has excess liquid assets, due to low demand from depositors for withdrawals, resulting in excess cash assets. It may then decide to reinvest assets in *less* liquid instruments, such as longer-dated repo transactions or higher yielding debt instruments. The fact that an individual transaction is risk-accretive should not mean it is prohibited if it is part of a liquidity management programme. To preserve value for shareholders, a ring-fenced bank needs to ensure that its resources (including its liquid assets) are utilised in an economically efficient way, especially in the current low interest rate environment, which may involve diversifying the holdings of the ring-fenced bank appropriately.

6.6. In this and other situations, it may be unclear whether specific individual transactions undertaken as part of a broader liquidity management policy would meet the "sole or main purpose" test under Article 6(2) of the EAPO. The sole or main purpose test applies on a transaction-by-transaction basis, with Article 6(1) of the EAPO referring to "a transaction", as opposed to a portfolio of transactions or a course of dealing. Article 6(1) of the EAPO goes on to state that the transaction, "either by itself or in combination with other transactions" should limit the extent to which the ring-fenced bank will be adversely affected by, inter alia, liquidity risk. Although this indicates that other transactions within the portfolio may be considered, it is unclear how many "other transactions" would be permitted or need be taken into account, what the relationship between those other transactions and the particular transaction under scrutiny would need to be, and what time period is relevant where there is a series of transactions, in order to pass the "sole or main purpose" test.[30]

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[30] Article 6(3)(a) of the EAPO separately permits ring-fenced banks to buy, sell or subscribe for liquid assets for the purposes of managing liquidity, but "liquid assets" for these purposes are a narrowly defined subset of assets which must qualify towards the liquidity coverage requirement under the revised Capital Requirements Regulation. See definition of "liquid assets", article 1(4) of the EAPO.

6.7. The PRA has commented on this topic in supervisory materials, but it is constrained by legislation, which is limited and, in some respects, impractical. The PRA expects ring-fenced banks to be alert to potential changes in the purposes of their transactions and to take "appropriate action" immediately where such changes do arise.[31] This comment may give rise to legal uncertainty, since neither the primary nor secondary legislation, nor the PRA supervisory materials, determine the point at which the purpose of a transaction might be regarded as having changed sufficiently to render it no longer eligible for the liquidity exemption. It is also impractical for a ring-fenced bank to monitor the satisfaction of this criterion, or to exit a transaction once a divined underlying purpose might be regarded as having changed, since to do so may damage the bank's overall liquidity or balance sheet position.

"Adverse effect" test

6.8. The "adverse effect" limb of the exemption under Article 6(1) of the EAPO creates additional difficulties of interpretation and legal uncertainties. This provision only permits ring-fenced banks to "deal in investments as principal" in order to limit liquidity risk, where that risk may "adversely affect" the ring-fenced bank in question. As described above, managing liquidity risk may from time to time involve changes in the portfolio of assets which have as their result the bank investing in less liquid assets. Additionally, as covered above, when doing so it will be necessary from time to time to balance or diversify the investment portfolio in accordance with a liquidity management procedure, so as to promote the good economic health of the bank and to act in the best interests of its customers and shareholders. Conducting liquidity management where these considerations are involved may not always limit the extent to which the ring-fenced bank is "adversely affected" by liquidity risk.

Securitisation

6.9. Article 7 of the EAPO contains an exemption which allows ring-fenced banks to purchase securitised bonds (under Article 7(2)) but only permits them to sell those bonds if they relate to a narrowly defined set of assets (pursuant to articles 7(3)(b) and 7(4) of the EAPO).[32] In practice, this means that ring-fenced banks will be constrained from selling

[31] The PRA, *Supervisory Statement SS8/16: Ring-fenced bodies (RFBs)* (December 2017), para 10.5 (Supervisory Statement 8/16 Update 'Ring-fenced bodies (RFBs)' December 2017 (bankofengland.co.uk)).

[32] Namely, assets issued or owned at any time by a company, or subsidiary of a company, that is the subject of an order under the Banking (Special Provisions) Act 2008 and that were transferred to the structured finance

securitised bonds unless they do so for any of the purposes listed under Article 6 of the EAPO (including to limit liquidity risk). For the same reasons as above, finding such an exemption can be problematic in practice. Moreover, this appears to create an inconsistency in the rules which could leave ring-fenced banks holding securitised assets that they are unable easily to divest, if there is not a clear liquidity or other risk which forms the "sole or main" purpose of the transaction under Article 6 of the EAPO

Solutions and mitigants

6.10. As discussed above, the liquidity risk exemption introduces several layers of legal uncertainty, with practical consequences. The exemption needs to be rethought and restated in a way which permits the activity of "dealing in investments as principal" to take place where this is part of a ring-fenced bank's broader liquidity management programme, in which the tenor, coupon, yield, credit risk, liquidity, diversity and balance of investments in the portfolio can be appropriately managed in a commercially reasonable manner and in a way that meets the bank's liquidity needs. This would arguably best be achieved by introducing broader language to the EAPO allowing transactions under such programmes, rather than by adding additional detail to cover the examples highlighted here. One way of eliminating these uncertainties would be to replace the "sole or main purpose" test with a test which looks to the "effect" of the transactions as a whole, with a presumption that transactions done under the ring-fenced bank's liquidity policy are permissible.

6.11. The "adverse effect" test should be removed, in conjunction with the changes recommended above. This would allow broader scope for ring-fenced banks to manage their liquidity effectively, whilst still ensuring that there were sufficient constraints under ring-fencing rules. Expanding the scope of the circumstances in which ring-fenced banks are permitted to sell securitised bonds under Articles 6 and/or 7 of the EAPO also assist the reduction of legal uncertainty.

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vehicle at a time when, amongst other things, the shares in the company were owned by the Treasury (article 3(2)(gc) of the EAPO), essentially being certain assets originally of Northern Rock or Bradford & Bingley.

7. THE IDENTIFICATION OF THE "ACCOUNT HOLDER"

Background

7.1. The concept of "account holder" under the ring-fencing regime determines whether the account concerned is a "core deposit." A deposit is not a core deposit if one or more of the account holders is: (a) a "relevant financial institution;" (b) a "qualifying organisation"; (c) a "qualifying group member"; (d) an "eligible individual"; or (e) a person who is, or at any time within the previous six months has been, subject to financial sanctions (Article 2 of the CAO). With respect to (b), (c) and (d), qualification/eligibility depends on the relevant person meeting certain criteria. Accordingly, the concept of account holder is crucial to the scope of the ring-fencing requirements since a bank will only be deemed to be carrying out a core activity if it accepts deposits that are core deposits. Further, as indicated above, the total core deposits held by a bank and, where applicable, a group, determines whether a bank is exempted from the ring-fencing regime by virtue of the core deposit level threshold specified in Article 12 of the CAO (see paragraph 3.1 above).

7.2. An "account holder" is defined in Article 1(3) of the CAO simply as "any person who has an account with an institution which carries on the activity of accepting deposits". It is somewhat doubtful whether the reference to "*an*" account means an account holding deposits (a "deposit account") or an "account" is to be construed more widely than a deposit account. On the basis that the legislation is concerned with the activity of accepting deposits, a reasonable interpretation would seem to be that "account" means deposit account and specifically, the deposit account with respect to which it is necessary to determine whether the person in question is the account holder.

7.3. More importantly, however, "person" is not defined, and more materially still, where legal and beneficial ownership of a deposit are split, the legislation does not specify whether the account holder - whose eligibility to bank outside the ring fence dictates whether the account is a core deposit - is the legal or beneficial owner.

Issues of legal uncertainty

7.4. Without a definition in the CAO itself, the definition of "person" in Schedule 1 of the Interpretation Act 1978 applies in principle: "Person includes a body of persons corporate or unincorporated". A trust can be a type of unincorporated body. It is therefore unclear whether, in the case of a deposit held on trust, a bank should consider the "account holder" to be the trustee, the beneficiaries of the trust or the "trust" in a more general

sense. A notable example of this issue is the case of large pension schemes with individual trustees who enter into the account contract on behalf of the scheme.

7.5. In light of this legal uncertainty, banks have to interpret the legislation in light of the stated policy objectives of the ring-fencing regime. From that perspective, it would seem to make little sense to regard the individual trustees of a trust such as a pension scheme, who may not qualify, in their personal capacities, as "eligible individuals" as the account holders. Their banking needs have no relevance to the needs (and ability to cope with disruption in services) of the pension scheme or its members as a whole. It would, therefore, seem appropriate in that case for the pension scheme as a whole to be treated as the account holder. In this regard, it is noted that charities (which may be organised as trusts) are expressly referred to in Article 5 of the CAO (*Qualifying condition for an organisation which is not a body corporate or a partnership*). However, unless the account is titled such that the trust is named as the direct customer of the bank, a bank may not feel comfortable regarding the deposit as being entered into by an organisation.

7.6. There may be a policy rationale whereby it is appropriate to distinguish the above example from trust arrangements where the trustee is holding for one or more disparate beneficiaries (such as a parent for one or more children). In such cases, the most reasonable approach would seem to be to treat the trustee as the account holder, at least where the trustee is a discretionary trustee.

7.7. In any case, the current lack of certainty is problematic and unsatisfactory, particularly when one considers the relatively clearer Depositor Protection Rules (Chapter 6) of the PRA. That is not to say that trust arrangements should be treated under the ring-fencing requirements in the same way as beneficiary accounts are dealt with by the Financial Services Compensation Scheme: the point is that there needs to be clarity for their treatment under the ring-fencing regime too.

Solutions and mitigants

7.8. It is important to clarify these matters in order to ensure that the scope of ring-fencing is applied consistently and that the intended policy purpose of the legislation is achieved. This would require changes to the legislation. These could specifically refer to pension schemes or could lay down principles as to when the customer should be regarded as the trust or fund rather than the individual trustee(s). In the latter event, additional regulatory guidance would be beneficial.

8. APPLICATION TO TAX EXPOSURES

Background

8.1. Most of the taxes imposed in the U.K. are imposed on particular legal entities rather than on groups as a whole. For example, corporation tax profits are calculated on a company-by-company basis even within a corporate group. Where that is the case and where there are no secondary liabilities imposed, a ring-fenced bank should not have a legal obligation to Her Majesty's Revenue Customs ("**HMRC**") in respect of any U.K. tax exposures of a non-ring-fenced-body ("**NRFB**). Whilst that is the basic position, there are a number of exceptions. The tax position of those is considered below.

Secondary liabilities for tax generally

8.2. There is a reasonable number of provisions which could, at least in theory, impose a secondary liability for unpaid U.K. tax of a NRFB on a ring-fenced bank. Some but not all of those provisions require HMRC to issue a notice in order to impose that secondary liability. By way of example, Sections 973 to 980 of Corporation Tax Act 2010 ("**CTA 2010**") give HMRC a power where an overseas incorporated entity has incurred U.K. corporation tax (usually as a result of operating a branch or office here) but has not paid it, under which it can by notice impose a secondary liability for that tax on certain connected entities. In the U.K., it is common for overseas banks to operate through branches", which means there are non-U.K. incorporated companies with U.K. corporation tax liabilities. If HMRC were to issue such a notice to a ring-fenced bank for unpaid corporation tax of a connected overseas entity, then the ring-fenced bank would be obliged to pay that tax but would be entitled to a statutory right of indemnity.[33] This scenario is extremely uncommon in practice but would be problematic if it did arise.

VAT groups

8.3. Where certain conditions (mainly around common control) are met, then each company in the corporate group has the choice to join a Value Added Tax ("**VAT**") group. There is no compulsion for any particular member of a corporate group to join or not join a VAT group. Where a VAT group is established, Section 43(1) Value Added Tax Act 1994 ("**VATA 1994**") provides that all and any business of the group is deemed, for VAT purposes, to be carried on by the representative member of the group. This has several

[33] Section 980 CTA 2010

consequences, including that (1) supplies between members of the VAT group do not give rise to VAT payment obligations;[34] (2) all output tax should be accounted for by the representative member, along with all input tax claimed;[35] and (3) under Section 43A of VATA 1994, all members of a VAT group have joint and several liability for any VAT that remains unpaid to HMRC. It follows that, if a ring-fenced bank and NRFB were VAT grouped, the ring-fenced bank could potentially be due an amount from the NRFB.[36]

Bank levy

8.4. The bank levy is calculated on a group basis. The relevant legislation is similar to the VAT grouping rules in the sense that there is an ability to appoint a "responsible member" of the group to deal with administration and payment aspects (paragraph 54 Schedule 11 Finance Act 2019 ("**FA 2019**")) and joint and several liability is imposed on various entities within the group (paragraph 53 Schedule 11 FA 2019). However, the legislation was amended in the Finance Act 2017 to provide that where a ring-fenced bank is not the responsible member then it is only jointly and severally liable for the amount that, in essence, would be payable, were the ring-fenced bank(s) all members of a separate group (paragraph 53A Schedule 11 FA 2019).

Transfer pricing

8.5. The transfer pricing rules in Part 4 of the Taxation (International and Other Provisions) Act 2010 require, in essence, that where services are provided between connected entities, U.K. corporation tax is paid as if an arm's length price had been paid for those services.

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[34] That is important because, in a similar way to consumers, makers of "exempt" supplies cannot recover the VAT on the costs they incur. Since a ring-fenced bank is likely to be making or exclusively be "exempt supplies" for U.K. VAT purposes, it will usually not recover a material amount of VAT on the fees it pays and other costs it incurs. In practice, where services have been provided intra-group to the ring-fenced bank, then historically the usual approach would have been to include the service provider(s) and the ring-fenced bank in the same VAT group where possible, thus reducing the irrecoverable VAT cost on those intra-group services. If that service provider is also providing services to any NRFBs, then, absent these ring-fenced bank rules the normal solution would have been to include all those entities in the same VAT group

[35] The representative member is also responsible for filing the VAT return with HMRC. Whilst the representative member makes those filings and payments to and from HMRC, most groups will re-allocate those amounts to the relevant members of the VAT group – whether under some sort of formal accounting or transfer pricing policy or otherwise. It is worth noting that NRFBs tend to have higher VAT bills rather than the ring-fenced banks. That is due to the broader range of services that a NRFB can offer, not all of which benefit from a VAT exemption.

[36] This would include situations in which the representative member of the group did not account for the VAT of the VAT group due for any particular period, when the ring-fenced bank might have to account instead, under the joint and several liability rules. In such a case, the usual result would lead to the NRFB owing an amount to the ring-fenced bank. In certain circumstances, mainly relating to providing certain services to individuals or entities outside the U.K., the ring-fenced bank may be entitled to recover some input tax. If that were recovered by a NRFB acting as representative member of the VAT group (or that otherwise reduced the VAT that the NRFB had to pay), then again that would lead to the NRFB owing an amount to the ring-fenced bank.

In practice, that tends to lead to a policy of actually seeking to ensure that such prices are paid intra-group for those services. There will usually be a formal "transfer pricing policy" setting out the pricing arrangements adopted. If and to the extent that the ring-fenced bank was to provide any service to a NRFB, the usual consequence under that policy would thus be that the NRFB should pay an amount to the ring-fenced bank. Transfer pricing arrangements are likely to benefit from the intragroup exemption for exposures under the ring-fencing rules (see 8.8 below)

OECD Pillar One

8.6. The recent announcement about proposed changes to the global tax system agreed under the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting provides a two-pillar solution to address the tax challenges arising from the digitalisation of the economy.[37] The Pillar One proposals seem to envisage that this tax will be calculated on a group basis. However, it now seems that there will be an exclusion for regulated financial services from the Pillar One rules. Whilst details of the relevant multilateral instrument and U.K. domestic implementing legislation are not yet available, it is anticipated that the exclusion would mean that the new rules will not cause concern.

Group use of tax liabilities

8.7. There are various tax attributes that apply group-wide, the main examples of which are group deductions allowance for loss carry-forward restrictions; group allowance for the temporarily extended loss carry back; and banking company tax surcharge allowance. The tax rules allow those to be non-proportionately allocated across a corporate group in such way as the taxpayers elect (subject to certain restrictions).

Issues of legal uncertainty

8.8. The intragroup exposure exemption under Article 14(4) of the EAPO permits ring-fenced banks to incur exposures to relevant financial institutions who are members of their group, provided that the exposure is not prohibited by FCA or PRA rules and the exposure results from a commercial transaction conducted on arm's length terms. However, it is uncertain to what extent the exemption can be applied to transactions such as those arising from VAT groups, which do not always have analogous commercial arrangements against which to benchmark an arm's length analysis.

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[37] OECD: *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy*, (July 2021), available at: https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2021.pdf.

8.9. Moreover, the relevant stated policy objective (limiting exposures and dependencies of ring-fenced banks to other non-ring-fenced members of their groups) does not clearly indicate or resolve whether the intragroup exemption or ancillary exemptions are intended to apply to the case of VAT groups. The ICB in 2011 recommended removing ring-fenced banks from VAT groups or amending the joint and several liability provisions of the tax rules with respect to ring-fenced banks;[38] it did not, however, consider all of the tax points above. To the extent that an exemption does not apply, there is also uncertainty as to when a potential future exposure is "incurred" (and therefore when and if a breach of the prohibition is said to occur). More particularly, it is unclear if a ring-fenced bank potentially breaches the rules by agreeing to be included in a VAT group, or if a potential breach would only occur at the point at which the ring-fenced bank makes a VAT payment on behalf of another person and creates an actual exposure.

Solutions and mitigants

8.10. These issues may be resolved by adopting one of the following courses of action. First, the relevant tax rules on VAT groups may be amended to modify the application of joint and several liability to ring-fenced banks. Following the approach of the bank levy, either: (i) joint and several liability could be disapplied in respect of ring-fenced banks; or (ii) the liability of ring-fenced banks could be limited to the VAT debts related to the activities of the ring-fenced bank. This would ensure that the tax rules recognised the economic independence of ring-fenced banks within groups, as established by the ring-fencing regime. Consideration could also be given to a more wide-ranging provision which would not cover just VAT groups but also the broader issues here. Under this approach, a provision in primary legislation would need to be introduced that, notwithstanding any other provision of U.K. tax law, a ring-fenced bank would not be liable to pay any amount on behalf of a NRFB (whether on a joint and several liability or secondary liability basis) where that payment would give rise to a prohibited exposure.

8.11. A second solution might be to amend, or provide additional guidance in relation to, the group transactions exemption in Article 14(4) of the EAPO to confirm that exposures arising in relation to the sorts of tax issues noted above can qualify for the exemption, where appropriate criteria are met.

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38 See *ICB Final Report, supra* n. 16, para 3.88.

9. THE APPLICATION OF THE REGIME TO TRADE FINANCE PRODUCTS

Background

9.1. There is an exemption, in Article 15 of the EAPO, from the prohibition on incurring financial institution exposures, for certain transactions with a purpose in connection with trade finance. The exemption is subject to the condition that the ring-fenced body enters into an agreement specifying "the supplies of goods or services to which the transaction relates" and "the maximum payments which the ring-fenced body may be required to make under the agreement."

Issues of legal uncertainty

9.2. The scope of this exemption leaves open to question or interpretation whether trade finance products which are considered standard in the trade finance market fall within it. For example, whilst documentary letters of credit (the confirmation of which may lead to a financial institution exposure, for example) may well specify particular supplies of goods or services to which they relate, a standby letter of credit may be given in relation to a number of different supplies over a period of time (potentially under different contracts) and accordingly may not detail those supplies in the letter of credit itself. Similarly, trade finance instruments like bills of exchange or promissory notes, which can give rise to exposures between financial institutions (particularly if instruments are discounted and transferred by financial institutions and/or avalised by others) may not contain details of specific supplies. It is not certain whether or not these kinds of arrangements (assuming they relate to the supply of goods or services as required by the exemption) are intended to be captured by the exemption. It could be, for example, that a ring-fenced bank could discount a customer's bill of exchange (where the requirements of the exemption are met) but could not purchase at a discount a bill of exchange purchased by another financial institution from its customer (because at that secondary stage the obligation has ceased to be linked to the underlying trade).

9.3. Further, trade finance is often conducted by financial institutions via participation arrangements with other financial institutions. For example, letters of credit are often issued by a financial institution operating as a fronting or issuing bank for a number of other financial institutions, and in this example the agreement giving rise to the financial institution exposure (which may be a facility agreement, for example) may not specify the particular details of the supply of goods / services or the maximum exposures (as these would be in the letter of credit itself as agreed by the issuing/fronting bank). Letters of indemnity are often issued by banks for their trade finance clients, to address the situation

where transport documents are not available: these instruments do not bear a maximum exposure. Debt factoring or discounting is often performed by a financial institution and then distributed to other financial institutions by way of participation or sale, and again the agreement between financial institutions may not detail the particular supplies giving rise to the discounted debts. That said, the relevant supplies would in the majority of cases by ascertainable by a combination of the agreement entered into by the ring-fenced body and the financial institution and the instrument issued to, or agreement with, the relevant third party.

9.4. There is no guidance as to what level of detail is required in relation to the supplies (i.e., whether the basic details including the parties, goods/services and transport details would suffice). Trade finance is also used where there is no underlying supply that is financed – to finance existing inventory in storage once it has been purchased for example. Such transactions would fall outside the exemption, which we suspect is not the intention. Finally, the exemption refers to "an agreement to *give effect* to a transaction" (italics added). A number of trade finance transactions are not "given effect" to by an agreement but are concluded under a master agreement. For example, receivables sales are often concluded by payment of the purchase price, rather than by written agreement.

Solutions and mitigants

9.5. Trade finance transactions take many forms and can be concluded directly or indirectly, so greater clarity would be helpful as to which standard trade finance products would or are intended to fall within the scope of the exemption, particularly noting that some relatively standard trade finance products (which might be expected to be within the scope of the exemption) may not contain sufficient details of specific supplies or otherwise meet the stated criteria. Having a non-exhaustive list of products that are intended to be within scope would be optimal (with scope for other products to be captured if they meet the general criteria).

9.6. An alternative partial solution might be to amend Article 15(b) of the EAPO to confirm that details of supplies of goods or services need only be specified in the trade finance product where the inclusion of such detail is in line with market practice (and clarifying the level of detail that might be required to be specified). Similarly, it would be helpful to provide guidance of whether transactions concluded under a master agreement fall within the scope of the exemption, or participations or secondary trades in trade finance products where the primary product falls within the exemption.

APPENDIX

Throughout this Report, the FMLC has made recommendations to resolve the legal uncertainties arising in the context of the U.K.'s bank ring-fencing remine. For ease of reference, these are compiled below.

The definition of "core services"

The definition of "core services" in section 142C of FSMA were amended (i) to make clear to which firms the references to accepting deposits, providing facilities for withdrawing money and providing overdraft facilities in that definition are intended to refer and (ii) to clarify what is meant by 'facilities' in that definition and whether this is intended to refer only to facilities provided by banks or to extend also to facilities provided by other service providers.

Ring-fencing transfer schemes

Any "business or asset" transaction between ring-fenced or the non-ring-fenced banks were allowed to fall within the scope of Part VII. In addition, it would be helpful if the court had power, in circumstances where a business transfer is made to a ring-fenced bank, to allow a grace period within which the bank may examine and address existing relationships.

The definition of "excluded activities"

Clarificatory wording and/or regulatory guidance on the interpretation of Article 20 of the RAO is recommended. A clarification of Article 6(4)(c) of the EAPO is also needed to remove uncertainty as to its scope and purpose. The FMLC suggests:

Providing regulatory guidance would reduce the need for constant revision of the EAPO.

A general updating of the RAO could usefully assess the impact of the RAO, as amended upon Brexit, on the CAO and EAPO.

The prohibition on "financial institution exposures"

Add an exemption to Article 14 of EAPO by way of a new clause (7) which allows a ring-fenced body to incur a financial institution exposure if the size of the exposure is below a fixed monetary threshold.

Amendment to the EAPO are as follows (changes in bold):

Article 14 of the EAPO:

(5) A ring-fenced body may incur a financial institution exposure in the course of buying, **selling** or subscribing for investments **for the purposes of to provide collateral in connection with** a transaction falling within paragraph (2) **or within paragraph (1) of Article 6, or selling investments acquired for that purpose**.

Amending Article 19A of EAPO in the following manner:

(2) For the purposes of this article—

(a) "financial assistance" means—

(i) loans **or finance lease arrangements**,

(ii) guarantees or indemnities, or

(iii) the purchase of bonds or notes.

(b) "infrastructure special purpose vehicle" means an entity the **only main** business of which (apart from incidental activities) is financing the acquisition, design, construction, conversion, improvement, operation and repair of infrastructure within the U.K. or the EEA **and acquiring, owning, and managing infrastructure as part of such financing arrangements, where, for these purposes, an entity shall include a segregated cell of a legal entity where, under the laws of its constitution, the legal entity is split into segregated cells such that creditors with claims on assets in one cell may not claim against the value of assets held in another cell.**

Liquidity management for ring-fenced banks

The liquidity risk exemption be rethought and restated in a way which permits the activity of "dealing in investments as principal" to take place where this is part of a ring-fenced bank's broader liquidity management programme, in which the tenor, coupon, yield, credit risk, liquidity, diversity and balance of investments in the portfolio can be appropriately managed in a commercially reasonable manner and in a way that meets the bank's liquidity needs. This would arguably best be achieved by introducing broader language to the EAPO allowing transactions under such programmes. The "adverse effect" test should also be removed.

The identification of the "account holder"

In order to ensure that the scope of ring-fencing is applied consistently, changes to the legislation are required to refer specifically to pension schemes or to lay down principles as to when the customer should be regarded as the trust or fund rather than the individual trustee(s). In the latter event, additional regulatory guidance would be beneficial.

Tax exposures

The relevant tax rules on VAT groups be amended to modify the application of joint and several liability to ring-fenced banks. Following the approach of the bank levy, either: (i) joint and several liability could be disapplied in respect of ring-fenced banks; or (ii) the liability of ring-fenced banks could be limited to the VAT debts related to the activities of the ring-fenced bank. This would ensure that the tax rules recognised the economic independence of ring-fenced banks within groups, as established by the ring-fencing regime. Consideration could also be given to a more wide-ranging provision which would not cover just VAT groups but also the broader issues here.

An alternative might be to amend, or provide additional guidance in relation to, the group transactions exemption in Article 14(4) of the EAPO to confirm that certain exposures can qualify for the exemption, where appropriate criteria are met.

Trade finance products

Providing a non-exhaustive list of products that are intended to be within scope of the exemption to the regime would be optimal (with scope for other products to be captured if they meet the general criteria). An alternative partial solution might be to amend Article 15(b) of the EAPO to confirm that details of supplies of goods or services need only be specified in the trade finance product where the inclusion of such detail is in line with market practice (and clarifying the level of detail that might be required to be specified).

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[39] Note that Members act in a purely personal capacity. The names of the institutions that they ordinarily represent are given for information purposes only.