UK review: the new regulatory sheriff in town is 'bail-in'

By Elisa Barwick

As savings rates soared during the COVID-19 pandemic, most banks around the world were able to apply their increased deposit book to larger speculative pursuits, raking in the profits. But not so seven large British banks[1] restricted by the so-called "ringfencing" separation of retail from investment banking which came into effect in the UK on 1 January 2019. Banks operating in the City are not happy, and have escalated their push to relax the rules and regain access to all that cash.

The ringfencing rule was a compromise to avoid a total "Glass-Steagall" separation of retail banks from investment banks, by requiring banks to section off the two activities from each other; nevertheless, it has had an effect in curtailing the bankers. A review of this policy, convened in late 2020, ruled effectively in favour of the gambling banks, but not with a determination that ringfencing doesn't work—in fact, the review admits that in many respects it is quite effective. Rather, the panel, led by City of London banking veteran Keith Skeoch and including ex-HSBC CEO John Flint, argued that ringfencing must be superseded by the "more comprehensive solution" of a fully functioning "bail-in" regime.

The bail-in, or resolution regime, is defined in the panel's final report, *Ring-fencing and Proprietary Trading Independent Review*: "The UK's resolution regime was established by the *Banking Act 2009*, of which a key element was the introduction of 'bail-in' powers for the Bank of England. This allows the Bank of England to use debt and equity that is held by investors to absorb losses and recapitalise a bank."

The Bank of England's (BoE) submission to the review added to the argument for bail-in to form the mainstay of regulation rather than ringfencing, on the grounds that ringfencing does not protect *all* banking functions critical to the economy, such as those allegedly provided by investment banking! Therefore, according to the argument, ringfencing neglects possible material impacts on financial stability, i.e. a crisis in investment banking could cause a financial crash. When ringfencing was adopted, "the services that were considered critical were taking deposits from, and providing overdrafts to, individuals and small and medium-sized enterprises (SMEs)", said the review. Whereas the bail-in resolution regime provides the BoE the legal powers to protect public funds and financial stability *across the board*.

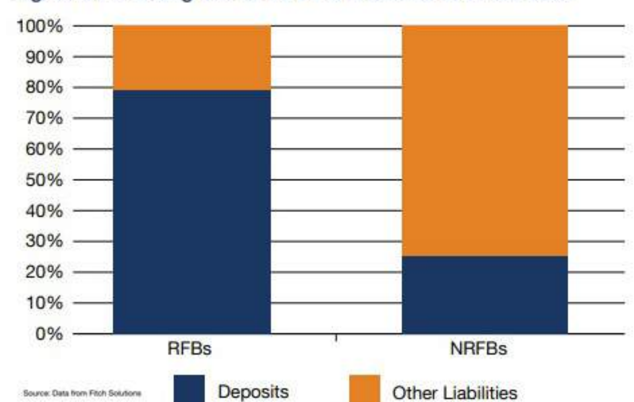
The report states that both regimes have evolved. The ringfencing regime had too narrow a focus, "But it is the resolution regime that is now overtaking ringfencing in providing a more comprehensive solution for tackling this issue."

Due to ringfencing, a tripling of excess liquidity in September 2021 over pre-COVID levels has likely resulted in "liquidity being deployed in the retail banking markets", depriving non-ringfenced bodies of money flows. Deposits have distinctly favoured ringfenced entities (box). The loan stock (loaned to business and productive enterprise) of ringfenced bodies has reached "the highest point in seven years", says the report, thus fostering the real economy. (Some of the rise at the tail end is attributed to government schemes during COVID-19.)

The review found no increase of market concentration of mortgages. Bob Diamond, a former Barclays boss who now heads investment firm Atlas Merchant Capital, had told the inquiry that ring-fencing regulations had reduced competition for products such as mortgages, by forcing banks to keep money in the retail banking arena. It was claimed that this forced smaller competitors including grocery supermarket lenders Tesco Bank and Sainsbury's Bank out of the market.

Ringfenced banks claim they are less competitive compared with their overseas rivals, as restrictions on access to deposit funding means their investment banking divisions have to raise more wholesale funding. Many of the complexities created by ringfencing raised by the review are actually reasons for full banking separation. A common reflection on the US depression-era separation rule, known as Glass-Steagall, is that it simplified bank regulation significantly. Full separation would prevent having to navigate the differing rules of two bodies under one roof—for example, regarding retail customers of ringfenced banks who operate in foreign markets that require more complex foreign exchange products (such as hedging contracts) provided only by non-ringfenced bodies. The review, however, did not find evidence of banks undermining or "tunnelling under" the ringfence, i.e. finding loopholes to break the rules.

The panel concluded that "ringfencing is worth retaining at present"; however, the regime's "benefit will diminish with time, especially as the resolution regime—designed to ensure the continuation of all critical functions across both sides of the ringfence in a banking group—is embedded." The continuity of retail banking services can then be ensured "without the need for structural separation". The resolution regime is declared a "more dynamic" and future-oriented approach. In the meantime, the panel recommends exemptions from ringfencing for banks that do not conduct excluded activities above a certain level and removal of banks from the ringfencing regime if they are considered "resolvable" by bail-in. Its conclusion is clear cut: "The resolution regime is now overtaking the ring-fencing regime in tackling too-big-to-fail."



Deposits flock to ringfenced banks

"Ring-fencing, by design, requires liquidity to be placed on either side of the fence. It prevents NRFBs [non-ringfenced bodies] from using retail deposits to fund investment banking activities. … [T]he regime has resulted in a change to the funding mix in the retail and non-retail parts of banks. This resulted in a concentration of deposit funding inside RFBs [ringfenced bodies] with a lower level of deposit funding in NRFBs. A Bank of England staff working paper estimated that the change in structure caused RFBs' share of funding from retail deposits to increase on average by 18 percentage points, while NRFBs saw an average reduction of 45 percentage points. Figure 4.1 depicts the variation of overall deposits in the funding mix of both RFBs and NRFBs in aggregate."

–Ring-fencing and Proprietary Trading Independent Review

1. Barclays, HSBC, Lloyds Banking Group, NatWest Group, Santander UK, TSB Bank and Virgin Money.

Bail-in and Glass-Steagall are diametrically opposed!

Ringfencing was recommended in the UK by the 2011 Independent Commission on Banking—a government inquiry into banking practices which examined regulatory failures leading to the 2008 crisis—in order to "protect depositors from risks arising elsewhere in the banks and in the financial system". An international debate had erupted around the necessity of a return to Glass-Steagall bank regulations, which outlawed deposit-taking banks from speculating. Ring-fencing is a "light" version of the 1933 US *Glass-Steagall Act*, because while Glass-Steagall forces deposit-taking banks to completely divest from investment banking or vice versa, ring-fencing means you merely separate those functions, which can continue to exist under one roof. Nonetheless it was a significant and controversial move, brought on by British MPs putting the common good ahead of the City's banks.

Table 2.1: Banking system assets as a share of nominal GDP

Source: Bank for International Settlements

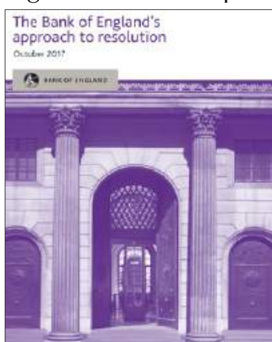
Country	Assets / GDP 2008	Assets / GDP 2010	Assets / GDP 2016	Number of Banks 2016
Hong Kong SAR	630%	692%	829%	195
Singapore	643%	548%	586%	128
United Kingdom	**531%**	**502%**	**392%**	**366**
France	384%	392%	388%	529
Switzerland	193%	207%	283%	261
Belgium	359%	310%	261%	90
Germany	311%	324%	250%	1888
Australia	216%	196%	246%	82
Japan	159%	169%	204%	370
United States	94%	86%	91%	5913

The UK is "an outlier for having legislated to specifically ring-fence activities", stated the final report of the review of the policy, "deemed to be warranted in the UK given the relative size of its banking sector to the economy" (which has declined since the 2008 crisis). Note Australia's position on the above list, and its relative growth. Photo: Ring-fencing and Proprietary Trading Independent Review

In December 2012 the Parliamentary Commission on Banking standards recommended "electrification" of the ringfence, to strengthen the regulators' power to enforce bank separation. And during a November 2013 debate in the House of Lords on the Financial services (Banking Reform) Bill, Labour's Lord Eatwell demanded a nuclear back-up option—that if ringfencing failed to suffice, full separation of banking must be pursued. Treasury Commercial Secretary Lord Deighton hit the nail on the head when he protested: "Glass-Steagall is not a supplement to ring-fencing, it is a separate alternative which would replace it; *it is a game-changer*." (Emphasis added.)

The ringfencing review noted: "One of the reasons that Parliament mandated a review into the ring-fencing regime following implementation was to assess whether banks were fully complying with the regime or if it needed to be 'electrified'. Electrifying the ring-fence means fully separating [bank functions], with each becoming separately owned banks. Regulators have restructuring powers that can be used to 'electrify' the ring-fence if a bank is found to be behaving in a way that undermines the objectives of the regime."

In fact, it is the review itself proposing ways to undermine the regime and its purpose is clear. The review's proposed cure-all—bail-in—is based not on saving depositors but saving banks and the speculative markets they make. As such it is quite the opposite of bank separation: allow banks full access to deposits in order to gamble, and if an entity goes bust allow it to appropriate depositors' and investors' funds to remain in operation, continue gambling, and in so doing protect the financial stability of the bankrupt system.



The Bank of England's 2017 bail-in manual, known as the "purple book". Photo: BoE

In its definitive 2017 "purple book" issued to cement bail-in as the accepted crisis-management mechanism, the Bank of England admitted the reason for the regime was to prevent national governments from taking steps to protect their own citizens: The bail-in resolution process, said the report, "greatly simplifies resolution and reduces the incentive for host authorities to ring-fence local assets for the protection of local depositors and creditors." ("Bank of England steps up global bail-in drive", *AAS*, 11 Oct. 2017.) There is no doubt the banking authorities wish to see the end of the politician-imposed ringfence experiment and will do anything to head off full Glass-Steagall measures. It would significantly disrupt City of London-Wall Street operations crucial to maintaining control of the world financial architecture.

Lloyds, HSBC, Barclays, NatWest and Nationwide have lobbied for changes to the ringfence scheme. The 8 February 2021 *Financial Times* noted that large US investment banks that were increasingly moving into deposit-taking operations in the UK had pushed to scrap the rule or at the very least to have the £25bn deposit ceiling, which invokes the ringfence rule, raised to £40bn. (The panel recommended the ceiling remain the same but was open to reviewing the activities excluded by the ringfence.) "The issue is of particular significance to Goldman", reported *FT*. "After founding a new UK retail bank called Marcus in 2018, it quickly grew to near the £25bn deposit ceiling and had to stop taking new customers. Goldman uses the deposits to help cheaply finance its London-headquartered international investment banking operations, a practice that would be banned if it had to ring-fence the unit." These matters would also bear heavily on the operations of another Wall Street bank, JPMorgan, said *FT*, which was about to launch its first digital-only retail bank in the UK. ("British banks push to wind back ring-fencing", *AAS*, 24 Feb. 2021)

On the other hand, British economist Sir John Vickers, who led the 2011 commission that recommended ringfencing, told *FT* on 21 March that the proposal to replace ringfencing with bail-in was "puzzling", countering that ringfencing would improve the resolvability of banks anyway, by separating them according to function. Even Sir Paul Tucker, the Bank of England deputy governor (2009-13) who chaired the G20 group that designed bail-in, warned that "until bail-in has worked in a massive live case, not just in desktop exercises", ringfencing should be retained to "protect citizens from banking Armageddon". Tucker infamously told a 5 November 2014 forum in Washington, DC that risk in the financial system must be borne by households so it would not "fall back on Wall Street firms".

The Treasury will establish a task force with the BoE and report back with its official response later in the year.