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PRA Consultation CP19/14 The Implementation of Ring-Fencing

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INTRODUCTION

This paper is submitted by the Financial Law Committee and the Insolvency Law Committee of the City of London Law Society and the Banking Reform Working Group of the Law Society of England and Wales (the "Committees"), in response to the Consultation Paper published in July 2014.

The City of London Law Society (CLLS) represents approximately 14,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government Departments, often in relation to complex, multijurisdictional legal issues. The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees.

The Law Society of England and Wales is the representative body of over 159,000 solicitors in England and Wales. The Society negotiates on behalf of the profession and makes representation to regulators and Government in both the domestic and European arena.

The Committees submitting this paper are made up of solicitors specialising in UK and international financial and insolvency law in a number of law firms based in the City of London, who advise and act for UK and international financial institutions and businesses and for regulatory and governmental bodies on financial and insolvency law matters.

1. OVERVIEW

1.1 We note that the language of the continuity objectives in relation to ring-fencing refers only to the UK and do not contain any contexting language. We refer you to the FMLC paper of February 2013 (available on the FMLC Website [and annexed to this submission]) at paras 2.1-2.9 inclusive commenting on this language before the legislation was enacted. This raised a concern that the continuity objectives set out at Box 1 of the Consultation Paper may indirectly discriminate against nationals of other Member States in breach of Article 18 of the Treaty for the Functioning of the European Union (TFEU), which is binding on the UK and affects both scope and validity of UK legislation (including primary legislation) and the actions of UK Government bodies and regulatory authorities. It gave examples of possible discrimination arising from following the objectives without regard to the consequences for nationals of other Member States as compared with those for UK nationals. However, no changes were made in the light of this concern.

1.2 This concern is reinforced in that the proposed EU legislation in the same area, (Draft Regulation on structural measures improving the resilience of EU credit institutions) states its objectives, which are more broadly framed in terms of preventing financial stress or the failure of large, complex and interconnected entities) by reference to "the financial system", without reference to any particular EU country. This Regulation, if passed, will also be binding on and in the UK generally, even if certain UK banks are not obliged to comply with certain of its requirements by reason of their being given an individual exemption. This will depend on existing UK legislation being accepted by the EU Commission as meeting certain criteria.

1.3 Where there is doubt about compatibility of UK legislation with EU law, the UK courts and authorities have a duty to give effect to the UK legislation consistently with EU law, so far as they practically can, and, if this is not possible, to apply EU law as an over-ride.

1.4 We would suggest that the PRA acknowledges the impact of Article 18 and publicly states that in pursuing its statutory continuity objectives it will be mindful of the UK's EU obligations and its duty to interpret, and act in carrying out, these objectives in a way compatible with EU law, including Article 18 on non-discrimination and other EU duties binding on the UK, such as under Title IV of the TFEU on the free movement of persons, services and capital.

2. LEGAL STRUCTURE

2.1 We welcome the common sense of much of the approach outlined by the PRA, in particular the acceptance that a ring-fenced bank will need to have subsidiaries itself and to operate with its own sub-group, although there will be limitations on what subsidiaries within that sub-group can do.

2.2 We believe, however, that there are certain areas for which exceptions from the normal rule may be needed, in particular with regard to excluded or prohibited activities.

2.3 An example is the question of insurance. Ring-fenced banks will clearly need to have a range of insurance for their own benefit (eg property, public liability etc). Many groups,

including banking groups use "captive" insurers to provide at least some of these services, which is effectively a form of funded self-insurance. For historic tax reasons, many of these captive insurers may be located outside the EU.

2.4 We recommend that the PRA carries out a study to determine what captive insurance arrangements a ring-fenced bank may have, whether separately or as part of wider group arrangements and then promulgate specific guidance and an appropriate amendment to Paragraph 3 of the draft supervisory statement on legal structure: we would not think that there could be any objection in principle to the use of captive insurance arrangements by ring-fenced banks or that there would necessarily be benefits in forcing them to only have captive insurance arrangements where the captive is established within the EU and/or is entirely independent of other parts of the group to which the ring-fenced bank belongs.

2.5 Though this may not affect corporate structure, and it is already contemplated that a ring-fenced bank may have a subsidiary which employs its workforce, we note that group pension arrangements are extremely difficult to disentangle without adverse financial consequences and it will be important to ensure that members of a group containing a ring-fenced bank are not placed at a disadvantage (whichever side of the fence they lie) as a result of enforced splitting of pension arrangements. Again this should be studied and guidance given.

3. GOVERNANCE

3.1 Again we welcome the indication that ring-fenced banks can operate their own sub-group structure and that proposals in this section as appropriate relate to that sub-group not just to the ring-fenced bank as a legal entity.

3.2 We think it would be helpful to clarify further that "other group members" throughout refers to entities that are parents or sibling companies of the ring-fenced bank (or of the holding company of the ring-fenced bank if it has a sub-holding company as the head of the ring-fenced sub-group) or subsidiaries of such entities and excludes subsidiaries within the ring-fenced sub-group itself. Indeed, much of what is said should be with reference to a "ring-fenced body sub-group" and not the ring-fenced body as a legal entity. We do not see reliance on subsidiaries as being a particular issue for resolution as these are under the control of the ring-fenced body (or any special administrator).

3.3 Again it is not clear that this dichotomy is fully recognised in the draft Ring-Fenced Bodies Instrument, which does not define either "ring-fenced body" or "group" or "sub-group". While some of these definitions may be elsewhere and we note the intention to have a further consultation on what constitutes membership of "a ring-fenced body sub-group", we would suggest that there needs throughout the Instrument to be an exclusion from the definition of "group" of companies that are part of a ring-fenced body sub-group. In addition we recommend that definitions of "group" and of "ring-fenced body" are added, even if they repeat or refer to definitions elsewhere, so as to improve clarity and ease of application of the rules in the Instrument.

3.4 The PRA recognises that there will be times when a ring-fenced body will need to share resources with the wider group, but it is not clear how the HR policy rules discussed at 3.32 are to be interpreted consistently with this recognition. Further guidance will be

needed that specifically addresses this issue. We appreciate that the proportionality rule discussed at para 4.14 in relation to continuity of services may be helpful in this regard.

3.5 Overall we are concerned that the rules may make it more difficult for a ring-fenced bank to deal with members of its wider group than with third parties and that is not in the interests of customers of the ring-fenced bank, because it will remove the commitment of the wider group to the continuity of the ring-fenced bank, which the legislation intended to preserve.

4. FUTURE CONSULTATIONS

4.1 We note and welcome the intention to consult further on aspects of intragroup and prudential arrangements and on the difficult subject of access to clearing. The effect of the legislation is that ring-fenced banks will seem to be unable to access clearing in major non-EU currencies directly and will need to access them indirectly to provide the banking services that customers need. Even small UK businesses, for example, may trade largely in US dollars, because that is the currency in which many commodities are traded.

4.2 We also note that the UK has an obligation under Directive 2014/59/EU (commonly known as the BRRD) Chapter III to permit group financial support agreements. A ring-fenced body therefore must be free to receive financial support in accordance with that Chapter from certain parent and sister companies and to agree to give reciprocal support and this needs to be provided for. The giving of such support could be described as the provision of a service and therefore it must be clear that restrictions on the acquisition of services or on non-reliance by a ring-fenced bank on the rest of its group do not, by a side-wind, prevent such agreements where they would be permissible under Chapter III: for example Article 8 of the Ring-Fenced Bodies Instrument as currently drafted appears to prevent such agreements. We note that Article 19(4) of the BRRD does allow some restrictions in the interests of financial stability.

4.3 The EBA has a current consultation on aspects of this topic: EBA/CP/2014/30, but it deals only with the general obligation not to place impediments in the way of group financial support agreements and does not illuminate how the exceptions to this specified in Article 19(4) are to be dealt with. This consultation closes on 4th January 2015. We recommend a dialogue with the EU authorities to establish a better idea of the restrictions on the ability of a UK ring-fenced bank to enter into such agreements will be consistent with Article 19(4).

5. THE PRA'S STATUTORY OBLIGATIONS

5.1 We would suggest that in future consultations this would be a good place to deal with the PRA's obligations in relation to general principles of EU Law binding on the UK (see comments in Section 2 above).

5th January 2015

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