Preparing for the **storm?**

The final report of the Independent Commission on Banking may have a significant impact on how compliance functions will need to be organised and structured. **Harriet Territt** and **Liz Saxton** consider new compliance challenges in a "post-Vickers" world

The final report of the UK's Independent Commission on Banking (ICB), chaired by Sir John Vickers, was published on 12 September 2011. The report sets out a number of recommendations and reforms aimed at improving stability in the UK banking sector. Key proposals include a requirement to ring-fence UK banks' retail operations, enhanced capital adequacy requirements for UK banks, and measures to provide preferential status to depositors insured by the Financial Services Compensation Scheme (FSCS) on any bank insolvency (currently, all bank depositors rank pari passu with unsecured creditors).

The ICB's recommendations are in the form of high-level principles and will require substantial and detailed legislation before they can be put into practice. The Government response to the ICB's final report is likely to be published in December 2011 and will include a suggested timetable for implementation of the recommendations. However, it is already possible to make some assessment of the impact of the proposed reforms on bank compliance functions (or, at least, articulate the issues that will need to be clearly addressed as part of the legislative process).

Ring-fencing

From a bank group compliance perspective, the most significant recommendation is the proposal to set up an operational and legal "ring-fence" around retail operations. Once implemented, certain mandated services that are essential to a retail banking operation (such as accepting deposits from individuals and SMEs) may only be conducted within a separate ring-fenced entity or part of the bank group. In the same way, the ring-fenced entity will be prohibited from conducting certain types of business, including proprietary trading and most types of derivative trading. The precise legal mechanism which will be used to effect this separation is being hotly debated (and is beyond the scope of this article). Rather, we focus here on the likely practical impact for bank compliance professionals, once the ring-fence is put in place.

Whilst the ICB recommendations stop short of suggesting full separation of retail operations, the requirements of the ring-fence proposal are significant. The ICB report makes clear that where a ring-fenced bank is part of a wider corporate group, the authorities must have confidence that it can be isolated from the rest of the group in a matter of days and can continue providing banking services without needing additional solvency support. To meet this high test, the ring-fenced entity will first need to have an independent governance structure, including a separate Board of directors. The ICB report suggests that, in many cases, the majority of these directors will need to be independent non-executives, with limits on when directors of ring-fenced entities can sit on the board of the parent or another part of the bank group. The ring-fenced entity will also need to be legally separate and operationally separable, and will need to transact with the rest of its banking group on an arm's-length basis, as if with an unconnected third party.

It is clear that, once this recommendation is implemented, ring-fenced operations will need to have a separate, independent compliance function in place. It seems very likely that such a ring-fenced compliance function will need to have separate reporting lines, including a right of direct access to the ring-fenced Board of Directors, in order to meet the requirement of operational separability. An interesting aside from the ICB report suggests the board members of both the ring-fenced bank and its parent company may be placed under a specific duty to maintain the integrity of the ring-fence, and to ensure the ring-fence principles are followed at all times. If this proposal is adopted, it will inevitably affect the approach to risk management and compliance across the group.

Separation anxiety

However, the ring-fenced entity (and its compliance function) also cannot act in total isolation from the wider bank group. This is acknowledged by the ICB report in two ways. Firstly, the ring-fencing requirement does not place any additional restrictions on the sharing of information and expertise within banking groups. Information about individual customers >>

(and presumably market information and expertise) can be shared within the bank group. In the same way, compliance professionals will obviously need to share information and adopt common policies and procedures across the bank group, in order to operate effectively and to comply with the UK regulatory framework.

In addition, operational infrastructure can be shared, although the ICB report suggests that the wider corporate group should be required to put in place arrangements to ensure that the ring-fenced bank has continuous access to all of the operations, staff, data and services required to continue its activities, irrespective of the financial health of the rest of the group.

In practice, allowing the ring-fenced entity to share operational infrastructure and information whilst remaining "operationally separable" will be a significant challenge. The ring-fenced entity will need an ability to access compliance databases, reporting systems and IT infrastructure, even if the wider bank group goes into an insolvency process. It will need to maintain its own separate client records for the same reason. Its employees could also need to be employed directly by the ring-fenced entity, rather than the wider bank group, with separate payroll and HR systems. Where third party suppliers provide essential services to an entire bank group, contracts may need to be renegotiated to ensure continued provision of services to the ring-fenced entity, even if the wider bank group is in default. The same issues will arise for other parts of the bank group such as operations, payments, treasury, risk and finance. Banks will need to either replicate functions on each side of the ring-fence (which has a clear risk of inconsistent approach and/or confusion), or find a way to organise these functions into a bankruptcy-remote entity within the group.

Complex issues

The requirement to treat the rest of the bank group as an unconnected third party for the purposes of inter-group transactions will also affect compliance processes. At a basic level, transactions with the rest of the bank group may require independent due diligence and more detailed compliance reviews. More difficult still will be ensuring that the ring-fenced bank is no longer party to agreements which contain cross-default clauses, or similar arrangements which are triggered by the default of entities in the rest of the bank group. Consideration will also need to be given to use of common terms such as "affiliate" in any new transaction documents.

These practical considerations have led some commentators, such as Lord Myners (the former Financial Services Secretary) to suggest that total separation of retail banking functions is inevitable in the longer term. However, given the length of time before the ring-fence requirement will come into effect (2019), it seems likely that banks can develop strategies for dealing with the issues identified in this article. What will be critical for affected bank groups going forward is that major legal, operational and risk management decisions from 2012 onwards take proper account of the upcoming ring-fence requirement. For example, if a proposed new piece of IT infrastructure cannot meet the challenge of operational seperability or a proposed group service contract cannot be extended at the bank's option to a particular subsidiary, it may not be in the group's interest to enter into a binding agreement at the present time. In the same way, banks should consider negotiating specific "change of law" clauses into relevant contracts to give a measure of flexibility for the future.

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