

UK BANKING REFORM: OBSTACLE OR OPPORTUNITY?

- The Independent Commission Review on Banking, published in September 2011, proposes radical changes to UK Banking and Financial Markets regulation
- This was in response to continuing Global Financial Markets instability and perceived weaknesses of the current UK Banking system
- The general view is that the recommendations from the “Vickers Report” will be adopted in to UK law
- These recommendations are far-reaching and will have significant implications for UK Financial institutions
- How should Banks and Financial institutions be preparing for these seismic changes?
- What options should they be exploring in terms of re-organisation of their businesses?

ARE THESE RADICAL REFORMS AN **OBSTACLE** FOR THE BANKING INDUSTRY TO OVERCOME, OR DO THEY PRESENT **OPPORTUNITIES** FOR ORGANISATIONS WHO ARE PREPARED TO EMBRACE THE CHANGES?

BACKGROUND TO THE REVIEW

The 2007 global Financial Markets crisis led to the run on Northern Rock and its subsequent nationalisation along with Bradford & Bingley.

Significant UK Government bail-outs then followed, to help preserve RBS and HBOS-LloydsTSB. These events, combined with similar financial crises across the globe, led the UK Government to announce the creation of the ‘Independent Commission on Banking’, chaired by Sir John Vickers.

The Commission was asked to consider structural and related non-structural reforms to help create a banking system that, amongst other things, “is much less likely to cause, or succumb to, financial crises and the huge costs they bring... so that the taxpayer is never again on the hook for losses that banks make”.

The Commission’s final report and recommendations were published in September 2011. Legislation is to be passed within current Parliament (by Spring 2014 latest), with final implementation to be delivered by early 2019, in line with the Basel III capital standards delivery timetable.

The proposed reforms are already having an impact, with RBS’s announcement of the divestiture of some elements of their investment banking business making headlines within a few months of the report’s publication.

2012 will be a key year for Banks to plan and prepare for the future.



The recommendations of the report will require banks to consider their:

- Products & customer strategy
- Organisational constructs
- Optimum operating model
- Governance model
- Controls & reporting
- Sourcing strategy

WHILE EACH OF THE RECOMMENDATIONS WILL HAVE FAR REACHING IMPLICATIONS FOR BANKS OPERATING IN THE UK MARKET...

RECOMMENDATIONS

1. 'Ring Fencing' of Retail Banks

- Retail Operations will need to be separated from other parts of the Bank to protect customers' interests.
- Only ring-fenced Banks can provide core domestic retail banking services of taking deposits and providing overdrafts to individuals and SMEs.
- 'Ring-fenced' Retail Banks must be self standing, separately capitalised, dealings with other parts of their organisation to be limited to those permissible under existing financial regulations for business between third parties.
- Ring-fenced Banks will not be able to undertake trading or markets business, including derivatives, other than for hedging retail risks.

2. Loss Absorbing Capabilities

A number of measures to reduce the need for government bailouts:

- Minimum equity capital of 10% of risk weighted assets (Basel III dictates 7%)
- Minimum primary loss absorbing capacity (equity plus long term unsecured debt), of 17-20% of risk weighted assets
- Depositor preference (insured deposits above all other unsecured debt)
- International standards to apply to activities outside UK retail subsidiaries

3. Competition

- Continued divestiture of Lloyds Banking Group, to allow the emergence of a strong challenger Bank.
- Introduction within two years of a seamless switching system for personal and small business current account holders.
- Stronger pro-competitive financial regulation via the newly formed Financial Conduct Authority (FCA).

IMPLICATIONS

Structural Implications

- Ring-fenced retail bank to be set up as a separate legal entity, operationally separable from other entities within its banking group to ensure it is able to continue providing services irrespective of the financial health of the rest of the group.
- Requirement to be self funded means appropriate provisions for solvency and liquidity must be made, potentially reducing the 'economy of scale' benefit from the wider corporate group.
- Board to be suitably independent from any wider corporate group, but common overall ownership of independent retail and wholesale banking divisions is still permitted.

Operational Implications

- As no specific Operational Model is prescribed, this is an opportunity for banks to structure their operations in the most beneficial way to them, whilst still meeting obligations of the proposed new legislation.
- No need for direct ownership of operational support infrastructure means that external suppliers could partner with the Bank(s)
- Crucial decisions are necessary about optimal Operating Model for the business that will inform strategy and the longer term success of the wider organisation in future years.

- In order to adhere to the recommended minimum levels of equity and regulatory capital, which exceed wider international standards, Banks may perceive that they are at a disadvantage internationally, compared to non-UK based Banks.
- Minimum capital requirements will differ for non UK Businesses as detailed under Basel III proposals.
- Global Banks with a UK presence will (and have) argued that only part of their organisation(s) should be subject to these regulations.
- There are likely to be minimum requirements for calculating and reporting on the capabilities both internally and to the regulators, which will most likely require system and process changes.

- Continued divestiture of the Lloyds Banking Group should lead to a more level playing field across the Banking industry, breaking down historically established barriers to fair market competition.
- Banks will need to take steps to develop and implement improved 'seamless' account switching processes for personal and small business account holders, by September 2013. Fastest movers will make the most of this opportunity to attract new customers, but will need to invest to deliver and see the benefits.
- Statement of objectives regarding pro-competitive regulation by the FCA are to be determined.
- Requirement for much greater transparency around service quality and costs.

...INTELLIGENT PLANNING CAN TRANSFORM AN APPARENT OBSTACLE TO SUCCESS INTO AN OPPORTUNITY FOR IMPROVEMENT

PRINCIPAL CONSIDERATIONS

Structural Perspective

- How will the separate legal entities (Retail and Wholesale Banks) be structured and what legal processes are involved?
- How will individual balance sheets be separated from existing consolidated accounts?
- What specific business channels should be included/retained in each Bank entity (Retail/Wholesale)?
- What does the new Governance Model need to look like?
- What additional controls are necessary to ensure 'intercompany' businesses do not exceed 'large exposure' limits?
- Are there benefits in relocating all or part of the business to a different jurisdiction?
- What further benefits can be derived from the new structure?

Operational Perspective

- What is the optimal Target Operating Model to support the new structure?
- Should you establish fungible or separate support infrastructures?
- What does the journey from today's infrastructure to your Target Operating Model look like and how will your people cope with the changes?
- Could a 'separate' shared service support function be created to service both entities?
- Could this be delivered internally or through partnership with a supplier in a Joint Venture or outsourced model? Which suppliers should be approached?
- Could its services be offered to other financial institutions – a revenue opportunity?

- What is the basis for calculation of equity and loss absorbing minimum capital balances (taking into account Vickers and Basel III recommendations) and what additional effort will be required of your people and systems?

- What is the most effective method for managing compliance to these requirements? i.e. what are the mechanics for daily calculation, monitoring and reporting?

- To what extent can new standards be built into existing reporting mechanisms?

- Is there an opportunity to automate reporting and improve transparency across other areas of compliance and control while implementing changes?

- What cost management or revenue generation initiatives can be implemented across the business to generate or retain funds contributing to the capital requirements?

- How does your organisation compare to today's market standards for retail and/or investment banking divisions? What does it need to look like in the future?

- What opportunities does the 'levelling of the playing field' bring for your organisation – what will your relationship with the 'challenger bank' be?

- How best can you capitalise on any first mover advantage in relation to 'seamless switching'? What is the most compelling proposition you can offer the market?

- Do you fully understand the systems and process changes that will be necessitated by these new regulations? How will you address them?

- What other opportunities will the proposed new fair competition regulations offer?

- How do you currently report on service quality and costs and where is there an opportunity to improve speed, accuracy and relevance of the metrics you derive?

KEY POINTS

Banks should move quickly to respond to these questions in order to gain 'first mover advantage'

A robust Target Operating Model is the starting point for transformation

Controlling cost, effort and risk exposure while maintaining quality of service through the transition will be a significant challenge

CONCLUSION

The Vickers Report recommends sweeping changes to the structures of UK Banks. Assuming that these recommendations become law, then UK Banks will need to start planning for these radical changes sooner rather than later.

The report's implications will pose a number of considerations for UK Banks, including:

- Target operating model design: What functions can or should be shared between the ring-fenced and non ring-fenced parts?
- Organisation & Governance: How will the two parts of the organisation be managed? What common reporting lines are needed?
- Customer proposition: To what extent will the two parts share branding? What new products could or should be offered to the market?

Mobilisation of teams to analyse the impacts and to decide the best strategies for your business is necessary. This impending challenge will only be met through effective change leadership.

However, this requirement for change offers opportunities for wholesale review of customer service and operating practices that, if managed correctly, could add significant value to your business.

Whether your organisation decides to embrace the change or reluctantly comply may impact on its ability to compete in the post-crisis environment.

WHETHER YOUR ORGANISATION DECIDES TO EMBRACE THE CHANGE OR RELUCTANTLY COMPLY MAY IMPACT ON ITS ABILITY TO COMPETE IN THE POST-CRISIS ENVIRONMENT.



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Steve is an experienced Senior Operations and Middle Office professional in the Financial Services sector, where he has operated at Executive and Management Committee levels for over 20 years at firms such as CSFB and Santander Bank. At Santander he was UK Head of Operations Global Banking & Markets, Insurance Services and Asset Management Divisions and was at the forefront of their strategic programme for Operations globally.

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ABOUT ELIX-IRR:

Elix-IRR is a strategic advisory firm that specialises in all forms of outsourcing, shared services and operating model design. We are comprised of senior professionals from consulting and services firms such as McKinsey, Deloitte, IBM and Accenture, as well as from industry from firms such as Citibank, Credit Suisse, Deutsche Bank, Santander and NS&I. This provides a rounded perspective for optimised strategic sourcing and operating model design in the Financial Services sector. We have delivered consulting services to financial services organisations internationally, helping them address the challenges of the current global financial services environment. In this context, we are currently involved with a number of banks to help design and implement substantial changes to support functions through development of improved Target Operating Models supported by robust sourcing strategies.



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