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**Retail ring-fencing of banks and its implications**

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Abstract:

Financial stability remains a key theme globally in view of the Eurozone debt crisis. The latest strategy by Germany and France is to ring-fence the crisis amongst the PIIGS countries: Portugal, Greece, Ireland, Italy and Spain. In the UK, the big four major banks have all responded to the Independent Commission of Banking's interim report key recommendation: ring-fencing retail operations into a separate subsidiary of any bank which wishes to operate in the UK. The report has clearly discussed the advantages and disadvantages of various types of subsidiarisation. Retail ring-fencing is considered a compromise since full subsidiarisation is too costly and operational subsidiarisation is too minimal. The Independent Commission of Banking published its final report on 12th September 2011. They recommended ring-fencing retail banking and a 10% equity baseline. This paper focuses on structural reforms of UK banks. It aims to address the question of financial stability from a wider European perspective. The first question is whether cross-border retail banking in the EEA is best served by branches or subsidiaries? The second question concerns the legality of setting up subsidiaries in the European Union. Whilst there are no legal problems for UK based banks setting up subsidiaries for their retail activities, there might be a legal hurdle for requiring foreign banks setting up subsidiaries in the UK. The third question concerns EU cross-border banking regulation and supervision. Are the 'passporting system' and the home country supervisory approach still applicable in this post-financial crisis era?

Many factors influence the choice of setting up branches or subsidiaries. However, the general position is that branches are more suited for wholesale/investment activities due to ease of funds transfer. Subsidiaries are more suitable for retail banking due to the limited liability principle and extensive local network. Effective cross-border banking must be accompanied by effective supervision and resolution regimes. The 'passporting' concept under EU law and home country dominance are somewhat dated post-financial crisis. Host country control should play a dominant part in financial regulation, especially in light of the importance of subsidiaries and the limited liability principle associated with them. The Icelandic bank crisis and collapse of Lehman Brothers International Europe illustrate the importance of host country control. Finally, the author argues that requiring banks to hold its retail activities in the form of subsidiaries in another European country is necessary to achieve financial stability.

KEYWORDS

Branches, financial stability, insolvency, retail ring-fencing, Special Resolution Regime, structural reforms, subsidiarisation

## Section 1: Introduction

In his Mansion House speech of 14th June 2011, the Chancellor George Osborne accepted the Independent Commission on Banking's proposal of partial bank subsidiarisation: that by building a capital buffer of 10% of risk-weighted assets around those retail banking operations, it would be easier to allow riskier investment banking operations to fail leaving the retail side of banking intact. Subsidiarisation may be seen as a compromise between politicians and bankers. Whilst the US government has implemented the Volcker rule, which is a form of full separation in that it prevents common ownership of banks and entities which conduct such activities, UK politicians have not taken the draconian step of full subsidiarisation. On 13th July 2011, Britain's major banks responded to the Independent Commission on Banking's interim proposals. They criticised the concept of ring-fencing and called for a cost benefit analysis (1). However, they acknowledged that ring-fencing is more than likely to be implemented. The issue is one of form. Santander advocates for a de minimis rule whereby banks with very small retail operations should be exempt from ring-fencing. Standard Chartered believe that ring-fencing the retail side of banks would impose a financial strain on taxpayers which would also encourage risky lending, They advocated for a narrow definition of retail banking and to permit funds transfer between different operations of banks (2). They rejected HSBC's proposal of a wider definition of retail ring-fencing should be done according to geographic operations. Subsidiaries will be set up according to the country where the business operates. The aim is to prevent cross-infection and contamination between the different subsidiaries. Geographical subsidiarisation is thus their policy. RBS called for a wide definition of ring-fencing to include parts of investment banking. Further, they argued that only UK based subsidiaries which already exist and identified by the FSA as holding more liquidity should be ring-fenced. Barclays meanwhile prefer 'operational subsidiarisation'-- ring-fencing the main operations of a bank (such as IT, third-party contract) when a bank fails but no prior division (2). The Independent Commission on Banking casted doubt over the adequacy of operational subsidiarisation whilst feared that full subsidiarisation is too costly (3).

On 12th September 2011, the Independent Commission of Banking produced its final report on the future of banking on 12th September 2011. The core proposal is that any significant bank wishing to carry out retail banking in the UK must place its retail activities in a separate subsidiary from its investment/wholesale activities. Branches (rather than subsidiaries) of foreign banks can carry out 'mandated services' (4) such as retail banking. This leads to the first question: is cross-border banking in the EEA best served by branches of subsidiaries?

This paper aims to address the question of financial stability from a wider European perspective. The first question is whether cross-border retail banking is best served by branches or subsidiaries? The second question concerns the legality of setting up subsidiaries in the European Union. Whilst there are no legal problems for UK based banks setting up subsidiaries for their retail activities, there might be a legal hurdle for requiring foreign banks setting up subsidiaries in the UK. The third question concerns EU cross-border banking regulation and supervision. Are the 'passporting system' and the home country supervisory approach still applicable in this post-financial crisis era?

The author accepts that partial subsidiarisation, whichever form it may take, will not provide a panacea to financial crises. Rather, it provides a partial solution to modern banking. This paper analyses the concepts of subsidiarisation and the UK insolvency regime in detail. This is useful in

shaping the future landscape of banking supervision and regulation in light of the sovereign debt crisis in the Euro zone. Financial stability is thus a main concern for UK banks.

This author will start off with a literature review of subsidiarisation in section 2, followed by a synopsis of the financial crisis of 2007-2009 and the effect of cross-banking in the UK in section 3. With the overriding theme of financial stability in mind, section 4 contains an analysis of the legality of setting up subsidiaries in the EU. Corporate governance issues are discussed in section 6. Section 6 discusses the UK Special Resolution Regime, which was required to rescue distressed banks in the UK. Section 7 is a discussion of EU supervision and insolvency framework. Finally, section 8 concludes.

## Section 2: Literature review

Subsidiarisation has been the buzzword in the UK for the past 12-18 months although it is not a novel concept. Ever since the collapse of BCCI and Barings Bank, policy makers and academics have discussed the advantages and disadvantages of subsidiarisation. BCCI collapsed in July 1991 primarily due to fraud. The BCCI incident was very complex, involving a complicated legal structure of the bank so that no single financial regulator would have overall oversight of BCCI. Hall (5) opines that '...subsidiarisation would not always be beneficial in a supervisory context — it might, for example, reduce the extent of 'parental' backing in an emergency...' Subsidiarisation allows the local regulator to have greater control over subsidiaries of banks. The BCCI case illustrates the difficulty of dealing with an international bank where a branch has failed. The failure of Icesave, a UK branch of Landsbanki, during the financial crisis of 2007-2009 again demonstrates the difficulty of modern day cross-border banking.

According to Hadjiemmanuil (6), Barings Bank in February 1995 failed due to unauthorised derivatives trading in its Singapore subsidiary. After Barings failed, the Bank of England ('the Bank') was appointed to conduct a review of the international organisation and operational procedures of Barings Bank. The Bank concluded that ineffective controls over Nick Leeson's unauthorised trading activities in an overseas subsidiary led to the demise of Barings Bank. Legal structure alone will not prevent corporate scandals. Ineffective controls and legal structure failed to prevent the latest authorised trading at the London office of UBS. An important consequence of the BCCI and Barings incidents is that Basel Accord of 1975 was updated. The Accord set out the principles of national regulators supervising financial institutions, whilst cross-border activities are supervised by both home and host countries.

Is cross-border banking best served by branches or subsidiaries? Three recent papers have discussed this question in detail. The first paper is by Cerutti et al (7) and the authors focused on the top 100 international banks in Latin America and Eastern Europe. They found that banks opt for the branch structure where the host countries have higher taxes and lower regulatory restrictions. Banks with ambitions to strengthen their retail side would normally prefer subsidiaries. Since parent banks are not legally liable for their subsidiaries due to the limited liability principle, banks prefer the subsidiary model where there are economic risks in the host country. Ring-fencing provisions limit the parent bank's liability to support its branches. Hence in extreme incidents of political upheaval and a branch becomes insolvent, the parent bank's liability is limited. It appears that this concept combined with smaller capital and reserve requirements in branches means that banks prefer establishing branches in host countries with political risks (7).

Dell'Ariccia and Marquez (8) agree with Cerutti et al's results. Risk is the principal factor in deciding whether a bank opts for a subsidiary or branch model in the host country. In general, subsidiaries are more suitable where there are high economic risks in the host countries due to the limited liability principle. Subsidiaries therefore take on more risks. Within the EU, the authors founds that subsidiary is the preferred option as political risks are low. They quoted a study whereby in 2006, bank subsidiaries hold 60% of total bank assets in EU new member states. Foreign bank branches only hold 6.5% of assets (8). The authors remarked that this result is rather surprising since EU legislation creates branches easily under the 'passporting' regime. Branches have the advantage of keeping capital within the group structure. With subsidiaries, there is a danger of capital being 'expropriated' by foreign governments (8).

Fiechter et al (9) submit that there is a range of factors influencing a banker's decision in whether branches or subsidiaries should be used. These factors include: regulation and tax levels of the host country as well as the bank's business strategy. If a bank's strategy is to focus on the wholesale market, branches are preferred. Branches are more centralised and easier to transfer funds across borders. It is more difficult to transfer assets across borders with subsidiaries due to stricter firewalls. Nevertheless, Fiechter et al state that global banks (such as HSBC) may prefer the subsidiary model since it focuses on local retail clients. HSBC's motto 'the world's local bank' can thus be better served by the subsidiary model. From the regulator's perspective, a UK bank wishing to expand into countries with weak economies and high business risks would prefer a subsidiary model. The host regulator may also prefer the subsidiary model due to the limited liability principle. Where countries have under-developed financial systems and need credit at the local level, then bank branches may be more suitable. The authors argue that the choice of branches or subsidiaries is dependent on factors such as: 'the quality of a country's supervision, the adequacy of its information-sharing and supervisory coordination, and the systemic importance of the affiliate for home and host financial systems' (9).

Ultimately, structure alone will not resolve financial crises. Whilst branches have the advantage of easy transfer of funds, subsidiaries have the limited liability principle and are less expensive to wind up in financial insolvency. Therefore, there must be effective and co-operative insolvency regimes at the European and international dimensions. Davies questions whether the subsidiary model is cheaper. He submits that: 'forced subsidiarisation would reduce the efficiency of capital utilisation in Europe and impose extra costs on the customers of European banks' (10) However, he is of the view that subsidiarisation is the way forward since it is difficult to achieve harmonisation of insolvency laws on the European level. This view is shared by Mervyn King and Lord Turner when they gave evidence at the Independent Commission on Banking Interim Report (3). The subsidiary model is easier for national regulators to deal with. The Commission concluded that the subsidiary model gives more control to national regulators and may prevent regulatory disputes. It acknowledged the shortcomings of the model but states that subsidiarisation may 'protect individual countries' fiscal bases and financial systems' (3).

Section 3: The financial crisis of 2007-2009

Cerutti et al (7) concluded by stating that there is a trade-off between branches and subsidiaries. Whilst the former is better when a foreign bank branch is financially distressed, the latter model is

more likely to expand the retail banking side of the parents. Subsidiaries are also more likely to establish larger networks. The financial crisis of 2007-2009 has revealed problems of both branches and subsidiaries. When Icelandic banks such as Glitnir, Landsbanki and Kaupthing ran into financial trouble, the Icelandic government did not have enough financial resources to compensate UK depositors. The UK government had to step in and provide compensation to UK depositors even though the Financial Services Authority only has secondary responsibility for regulating and supervising the branches of these Icelandic banks. Primary responsibility of supervision lies with the Icelandic regulator because the EU Second Banking Directive 1989, the Home State has primary responsibility for prudential regulation of branches. Although Iceland is a non-EU member of the European Economic Area (EEA), it is legally bound to implement into its own law all EU directives applicable to the free movement of goods, persons, services and capital. Whilst Cerutti et al's submission that branches are more likely to expand the retail side of banking is true, the Icelandic bank episode has raised concerns of establishing bank branches in other Member States in the EU. This procedure is commonly known as 'passporting', found in Article 23 of the Capital Requirements Directive. If Barclays wish to set up a branch in Belgium, they merely need to notify the Belgian authorities. Lehman Brothers adopted a subsidiary model but this did not prevent its UK subsidiary from collapse.

Although the parent company Lehman Brothers is legally distinct and separate from Lehman Brothers International Europe, the parent company's exposure to US subprime mortgages and its high leverage affected Lehman Brothers International Europe. According to Zingales (11), Lehman Brothers had a leverage of 33 to 1 at the beginning of 2008. This is twice the average leverage of 15 to 1 of commercial banks. A drop in 3.3% in assets value would wipe out the entire value of equity and insolvency proceedings would follow. Lehman Brothers International Europe utilised an accounting device called Repo 105 which masked the size of Lehman Brothers's balance sheet. There was pressure for investment banks such as Lehman Brothers to reduce their leverage at the end of 2007. Even if Repo 105 was not lethal, it was certainly poisonous. Lehman Brothers had been abusing it as far back as 2001, using repurchase agreements to finance assets but, unlike with typical repo transactions, treating them for accounting purposes as sold. This enabled Lehman Brothers to cover up its true leverage, making it seem lower than it actually was. Lehman Brothers International Europe took the lead role in Repo 105 transactions. This is because Lehman Brothers (the parent company) had difficulty complying with SFAS 140, the US accounting rules. They could not obtain true sale transactions, which meant that assets could not go off-balance. The leverage ratio was thus not reduced. In the UK, Linklaters, a London based law firm was able to obtain true sale status for Lehman Brothers International Europe. Anton Valukas states in his report: "Although the Linklaters's letter was written for the exclusive benefit of Lehman Brothers International Europe, a significant volume of Lehman's Repo 105 transactions was executed for the benefit and using the securities of one or more US-based Lehman entities" (12). It is important to note that there is no evidence that Linklaters acted illegally. Regulatory arbitrage succeeded here due to difference in international financial regulations and standards. This lacuna in accounting and financial regulation must be addressed immediately. Accountants and lawyers must co-operate to stop regulatory arbitrage.

The second problem was the inability of UK insolvency law to deal with the situation. As Lord Turner said: 'global banking institutions are global in life but national in death' (13). UK corporate insolvency law was inadequate in dealing with the financial crisis. Corporate insolvency law 'deals only with institutions that are already drained of economic value' (14). This is too late for banks. When banks

are in financial distress, time is of the essence to minimise externalities. Government authorities need powers to rescue banks immediately to avoid widespread panic. These powers were lacking under the UK corporate insolvency regime. The FSA were thus unable to take control of Northern Rock quickly when the latter was technically still solvent. This made it difficult for the FSA to sell Northern Rock since it had already lost franchise value (15). The FSA was unable to rescue Lehman Brothers International Europe on the same principle even though in theory, they had more supervisory control over subsidiaries than branches.

Reputation and goodwill of a business might save its subsidiaries. Even if the parent bank is not legally obliged to rescue the ailing subsidiary, the former may be so concerned about the reputation of the banking group as a whole that it will rescue the subsidiary. Professor Goodhart gave the example of Bear Stearns when he gave evidence before the Independent Commission on Banking. Bear Stearns had several hedge funds operating as subsidiaries. They were exposed to the US sub-prime crisis and Bear Stearns rescued these hedge funds due to reputational concerns (16). Lord Turner mentioned in his review that the German government supported Hypo Real Estate despite the fact that it was its Irish subsidiary where most of the problems began (13) Thus, reputational risk may displace the danger of moral hazard, where the concern is that a bank will allow its subsidiary to collapse. Moral hazard is classical incentive problem (17). It takes place when 'the principal cannot observe the agent's behaviour but can see the optimality of the behaviour' (17). As shareholders are dispersed and the 'exit' approach is favoured in the United Kingdom, shareholders (principals) find it difficult to monitor bankers (agents). There is thus a danger of excessive risk-taking in the absence of close monitoring. The rescue in Bear Stearns appears to alleviate the fear of moral hazard.

Kahn and Winton go further and argue that subsidiaries will decrease moral hazard (18). Kahn and Winton's model shows that by putting bad loans into a subsidiary, this would protect the rest of the assets. There will thus be a bipartite system, with good loans in one subsidiary and bad loans in another. Moral hazard is in Kahn and Winton's view, 'the bipartite structure improves incentives, not because investors can better observe the institution's actions or loan quality, but because this structure reduces potential gains from risk shifting' (18). Time will tell whether Standard Chartered's concern of an increased risk in moral hazard if retail banking is severed from the rest of the bank is a real danger in practice. In any case, a bank levy on banks should be made compulsory so that the cost for bank rescues is internalised. The Independent Commission on Banking's recommendations of holding more equity and creditors (rather than taxpayers) absorbing losses are welcomed (3). In the view of the Independent Commission on Banking, 'loss-absorbing debt is essential to resolution. The two are complements'(4). Equity is better than capital because the former 'is the only form of loss-absorbing capacity that works both pre- and post-resolution'(4).

## Section 4: Legality of subsidiaries under EU law

The Independent Commission on Banking Final Report states that 'mandated services' (retail banking) could be provided in the UK by branches of foreign banks, although any significant banks based outside the EEA wishing to carry out mandated services in the UK should generally be required to establish a UK subsidiary. De la Mata Munoz (19) has raised an interesting point about the legality of cross-border subsidiaries within the European Union. This will be of interest to foreign bank challengers wishing to provide retail banking activities in the UK. He submits that forced

subsidiarisation for cross-border banking is against the European principle of freedom of establishment enshrined in Article 49 of the Treaty of Freedom of European Union (TFEU). The argument is that companies have the option to run businesses in the EU as branches, agencies or subsidiaries. Therefore, forced subsidiarisation is invalid under EU law. There are exceptions to freedom of establishment available under the TFEU, such as Articles 51-55. De la Mata Munoz opines that Article 51.2 TFEU has never been used to justify a restriction of activity within the EU. Further, EU case law such as Commission v. France (Case 270/83) is an illustration where the European Court of Justice has applied a very narrow approach to the exception. De la Mata Munoz then argued that the use of subsidiaries has an overriding general interest such as financial stability. Nevertheless, he argued that this was unnecessary because regulation can rectify the existing problems. Measures such as 'reinforcing host country control, increasing regulatory convergence and enhancing supervisory standards' should address weaknesses of cross-border banking (De la Mata Munoz 2010). He concluded that forced subsidiarisation is in breach of EU law. If this view is adopted, then a foreign bank cannot operate retail activities in the UK since Vickers's recommendation requires a subsidiary model for all retail activities in the UK. The case of Societe Papillon v Ministere du Budget, des Comptes Publics et de la Fonction Publique (C-418/07) confirmed the narrow interpretation of proportionality in EU jurisdiction. In this case, a group taxation regime was held as a restriction on the freedom of establishment contrary to Article 43 of the EC Treaty. Although the taxation regime was necessary to harmonise tax systems, this went beyond what was justifiable to achieve the aim of harmonisation.

Is forced subsidiriasation justifiable to achieve the aim of financial stability? Financial stability is achieved through a trio of structural reform, macro and micro prudential regulation and corporate governance. Structural reform includes the subsidiary model. Arguably, if a foreign bank operates through a branch in the UK and it has sufficient equity to absorb the losses, then forced subsidiriasation is not justifiable to achieve financial stability. Forced subsidiriasation may be seen as a backup in case there is insufficient loss-absorbing equity in a bank. Whilst it is possible to amend Article 49 TFEU so that a bank can operate in the UK as long as it holds sufficient loss-absorbing equity, this is unlikely to be viable in practice. First, the levels of equity in a bank fluctuate regularly and frequently. It may be too late to find sufficient liquidity to rescue a failing bank in time. Secondly, the Special Resolution Regime under the UK Banking Act 2009 applies to UK subsidiaries of foreign banks but not to UK branches of foreign banks. It would be undesirable for the FSA to be prevented from rescuing branches of foreign banks in times of crises, especially international ones. Banks are interconnected and an effective resolution regime is necessary to minimise systemic effects of bank failure. Thirdly, branches and subsidiaries are governed by different supervisory and regulatory frameworks in the EU. Home country supervision should be replaced by host country supervision to provide a more effective supervisory regime in the EU. Host country intervention is needed in times of crises. This is further discussed in section 7. Therefore, it is submitted that subsidiarisation is justifiable to achieve the aim of financial stability.

Two European policymakers, Vicky Ford and Thomas Huertas, have warned that the increasing use of covered bonds are ringfenced for bondholders, leaving depositors with fewer assets.(20) Covered bonds are debt securities backed by cash. They are tied to mortgages but they remain on the bank's balance sheets. The expectation is that they will be included in ring-fencing. However, the definition of 'mandated services' is narrowly defined in the Independent Commission on Banking. 'Mandated services' only cover deposits and overdrafts to individuals and small and medium sized organisations.

The rationale of ring-fencing the retail side of banks is to protect depositors. The common belief is that deposits are used to fund investment banking. Since the latter is considered as riskier, depositors are in danger of losing their deposits. According to a recent research by Deutsche Bank, this belief is misguided. Apart from HSBC where they wholly fund its retail division by deposits, all the other major banks do not have sufficient deposits to do so (Volk B cited in Alloway 2011). In fact, there is an estimated funding loan/deposit funding gap of £150,000. One solution to fund this gap is via products such as covered bonds. There is a complication with covered bonds though. The assets which back residential mortgage based securities and covered bonds are not available to depositors immediately. The effect of this is that the loan/deposit ratio will decrease if residential mortgages backed by covered bonds and residential mortgage backed securities are excluded. An example was given in relation to Barclays (Volk B cited in Alloway 2011). Without ring-fencing, loans encumbered for covered bonds constitute 2% of assets. Depositors therefore have access to 98% of unencumbered assets. Deposits form 24% of liabilities. With retail ring-fencing, total unencumbered assets only constitute 80% of assets whilst deposits form 81% of liabilities (Volk B cited in Alloway 2011). The recommendation made by Volk is to place a limit on how much banks can rely on covered bonds for funding. This is very sensible. It would be desirable for European and international legislators to impose a restriction on covered bonds. Until such restrictions come into force, banks should improve their loan/deposit ratio. The counter-argument of improving the loan/deposit ratio is that reducing leverage will reduce profitability. There is empirical evidence that there is a negative relation between profitability and leverage ratios (21), (22), (23). However, Long and Malitz (24) do not find such a relation between leverage and profitability. Naturally, profitability of banks is affected by a range of factors, both external and internal. Therefore, leverage is only one factor which affects profitability. Co-operation from banks is needed to maintain financial stability in the UK market.

## Section 5: Corporate Governance

The final element of the trio to financial stability is good corporate governance. The response from Elphick (25) to the Independent Commission on Banking Report emphasises corporate governance. It is worth noticing that Elphick has drawn on his experience on the success of ring-fencing in the water industry. Wessex Water was ring-fenced and a subsidiary of Azurix Europe Limited and Enron (26). When Enron collapsed in December 2011, Wessex Water survived due to the subsidiary model. The success of the subsidiary model in the water industry is not necessarily guaranteed in the financial sector. However, we can learn from this success and see what improvements we can make. Elphick believes that the ringfenced company should have an entirely separate board to its parent.

Ofwat requires the ringfenced company should 'act independently of the parent company or the controlling shareholder' (25). This is particularly important where the investment banking arm is in financial distress. The retail banking subsidiary would be under pressure from its parent. Independence of board, which includes an independent chair and non-executive directors, is vital to financial stability. Good financial regulation goes hand-in-hand with good corporate governance practice. The Basel Committee on Banking Supervision (BCBS) has called attention to the need to study, understand, and improve the corporate governance of financial entities. Independence of the board is a vital concept in corporate governance. The justification is that objectivity and impartiality

can be exercised when making decisions when the board is independent. Mere rubber-stamping decisions and strategies undermine board effectiveness. De Andres and Vallelado (27) used cross-country evidence and demonstrated that bank performance has an inverted U relationship with board size and more outside directors will improve performance. Pathan (28) supports this conclusion as well, who also argued that more independent directors appear to lead to low risk-taking. Arguably, independent directors are good for corporate governance. They control risk-taking and produce better performance. It is therefore right to support paragraph (g) of the final principle on ring-fencing of the Independent Commission on Banking (4). Paragraph (g) states that:

*'the board of the ring-fenced bank should be independent. The precise degree of independence appropriate would depend on the proportion of the banking group's assets outside the ring-fenced bank. Except in cases where the vast majority of the group's assets were within the ring-fenced bank, the majority of directors should be independent non-executives of whom:*

*i. one is the Chair; and*

*ii. no more than one sits on the board of the parent or another part of the group'.*

Through the provision of (g)(ii), conflict of interest would hopefully be eradicated. This is a common problem identified by Allen et al (29), where some of the directors in the subsidiary board also held positions in the parent bank. This is worrying in view of the conflict of interest. Subsidiaries are legally independent entities and are subject to the host country's regulation and supervision. Lehman Brothers' UK subsidiary was subject to British regulation even though it was a US bank. A conflict of interest scenario could arise if a director sits on both the parent and subsidiary boards and the subsidiary is facing financial difficulties. Should the director act in the best interest of the parent company or the subsidiary? This is an unsatisfactory situation and under section 175 of the UK Companies Act 2006, the director concerned should be advised to either remove the conflict in the first place or to resign. Therefore, Allen et al (29) opined that foreign banks must include independent non-executive directors on their boards to make sure that the management is following the regulation and acting in the best interest of the local institution. The author so far supports the Independent Commission on Banking's recommendations on corporate governance.

Independence alone however, is insufficient on boards of banks. A recent paper by Allen et al (29) studied the corporate governance structure of listed foreign subsidiaries in host countries. Their results revealed that the number of independent directors with financial expertise is low. This is worrying as modern banking is complex. Securitisation and financial products are difficult to grasp. It is therefore advisable that bank board should have directors with financial expertise who can understand the risks involved. David Beatty of the Rotman School of Management believes that the emphasis on expertise is important for bank boards. The Sarbanes-Oxley Act 2002 states that the chair of the Audit Committee must have solid financial credentials and members of the audit committee were expected to be 'financially literate.'(30) Beatty added that it would be desirable for boards to have a risk expert as well as a compensation expert. The Sarbanes-Oxley Act 2002 had a spillover effect on Canadian corporate governance. The UK Corporate Governance Code has not followed suit in this area. However, it is submitted that the 'expertise model' advocated by Beatty makes sense and adds value to company boards. Risk management in many banks failed during the financial crisis. Excessive leverage, poor internal controls and financial ratios led to liquidity

problems in many banks. The UK Corporate Governance Code Main Principle C.2 Risk Management and Internal Control states:

*'The board is responsible for determining the nature and extent of the significant risks it is wiling to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems.'*

Code Provision C.2.1 provides:

*'The board should, at least annually, conduct a review of the effectiveness of the company's risk management and internal control systems and should report to shareholders that they have done so. The review should cover all material controls, including financial, operational and compliance controls.'*

In addition Financial Services Authority DTR 7.2.4R requires companies to describe the main features of the internal control and risk management systems in relation to the financial reporting process. The Financial Reporting Council is currently considering whether the Turnbull Guidance on internal controls needs to be revised after meeting company directors and executives in December 2010. In particular, questions such as who is responsible for oversight and operational management will be discussed. How should the board, board committees and management interact? It is submitted that the Financial Reporting Council should also consider the necessity of having expert directors in finance, risk and compensation.

Therefore, the author submits that forced subsidiarisation of retail ring-fencing can be justified on grounds of financial stability. Protection of depositors and taxpayers is of paramount importance, especially in light of the financial crisis of 2007-2009. The trio of the subsidiary model, corporate governance and macro/micro regulation is fundamental to achieve this aim.

## Section 6: UK Special Resolution Regime

The financial crisis of 2007-2009 has shown the spill over effect of banks when the UK government had to nationalise Northern Rock and Bradford & Bingley, as well as injecting £850 million into the Royal Bank of Scotland and Lloyds Banking Group. With the former two banks, the UK government faced the choices of insolvency or nationalisation. The existing UK insolvency law did not provide a mechanism to resolve a financially distressed bank. The Bank Special Provisions Act 2008 was passed on 21st February 2008 to facilitate the nationalisation of Northern Rock and Bradford & Bingley. It was also used to resolve the UK entities of various Icelandic banks. The priority of the UK government during the financial crisis was to limit the costs of bank failures within the industry. The Banking Act 2009 on 21st February 2009 replaced the Bank Special Provisions Act 2008 and contains a Special Resolution Regime (SRR) to deal with distressed banks. To date, only Dunfermline Building Society has been resolved by the SRR. Therefore, the SRR has not yet been tested against UK banks with cross-border activities.

Would the SRR be equipped for distressed UK banks with cross-border activities? The SRR applies to foreign branches (but not foreign subsidiaries) of UK banks. It also applies to UK subsidiaries of foreign banks but not to UK branches of foreign banks. The SRR would thus be able to deal with the

UK subsidiary of Lehman Brothers should a similar scenario takes place. The SRR allows foreign authorities ring-fencing local assets of UK bank branches (not subsidiaries) of foreign banks. Hence, if Bank of America's UK branch is in distress, the American authorities have full power to ring-fence the assets of the UK branch. This seems sensible in theory given that branches are part of the parent while subsidiaries are separate legal entities and locally incorporated. The UK were somewhat fortunate in the financial crisis since the banks which were nationalised were primarily domestic (31). There was no international element to Northern Rock or Bradford & Bingley. The SRR thus compliments and supplements the subsidiary model.

Over the past 18 months, the banking crisis has since evolved into a sovereign debt crisis. There is a likelihood of cross-border spill over if there is a sovereign debt restructuring of Greece (15). According to the Bank of England's Financial Stability Report of June 2011, although UK banks only have a moderate direct exposure to sovereign debts in Greece, they are exposed to other Euro zone countries such as France and Germany. France and Germany have large exposures to weaker countries in the Euro zone. Any default or stress in the Euro zone is likely to affect UK banks negatively (15). UK banks have avoided the impact of the sovereign debt crisis so far because they have reduced their leverage and increased the amount of capital. However, the Euro zone is still heavily reliant on the wholesale market, with almost 50% of its loans borrowed from the wholesale market (15). Therefore, UK banks are prone to systemic risks and it is essential to have effective cross-border insolvency resolution, at least on the European level. The author agrees with Davies (2010) that in practice, international co-operation of global banks is very difficult to achieve due to political factors. Therefore, one must start at the national level before moving onto co-operation at the European level. Nonetheless, national regulators should strive to co-operate on the European level.

Section 7: EU supervision and insolvency framework

The current EU supervision framework provides that the Home State has primary responsibility for prudential regulation of branches. The host Member State authorities have responsibility for liquidity regulation, in co-operation with Home State authorities. Finally, the deposit protection regimes are national. Subsidiaries follow the local deposit protection regime in the host country whilst branches are protected by the bank's home country.

| | | **Branch** | | | **Subsidiary** | | |
|---|---|---|---|---|---|---|---|
| | Prudential Regulation | Liquidity Regulation | Deposit Insurance | Cross-Liability | Prudential Regulation | Deposit Insurance | Cross-Liability |
| Home unit | Home Regulator | Joint | Home | Yes | Home Regulator | Home | No |
| Foreign unit | Home | Joint | Home | Yes | Host | Host | No |

Source: Adapted from Calzolari & Loranth, 2005 (32)

The principal tenet of the current EU supervision regime is nationalism. Responsibility for financial stability is national. Supervision/regulation is national with only some exceptions. This model is clearly dated in light of modern banking. The author submits that a more European approach to supervision is necessary. As Mervyn King and Lord Turner favour the subsidiary model, the implication is that the host supervisor will have more role in supervising foreign banks (33). This is necessary to ensure that foreign banks' levels of capital and liquidity are sufficient. Buiter favours this approach (34). He submits that the European tradition of home-country dominance is unworkable. In the collapse of Icesave, a branch of Landsbanki, it was the UK, not Iceland, which felt most of the pain. Again with the collapse of Lehman Brothers International European, the UK bore the brunt of the financial disaster. Therefore, it is only logical that the host country regulator should take a leading role in regulation and supervision of cross-border banks. Article 40 of the Capital Requirements Directive should therefore be amended so that the host (not the home) supervisor has more supervisory powers.

The European Commission is currently drafting the Capital Requirements Directive IV (the Directive). The Directive adopts a 'multi-dimension' to regulation and supervision (35). It has regulations on capital, liquidity and leverage ratios. These ratios reflect the balance sheets of banks better than solely concentrating on capital requirements. In addition to Basel III implementation, the proposal introduces several important changes to the banking regulatory framework. The Directive calls for enhanced governance. In the opinion of the European Commission, the self-regulatory nature of corporate governance led to weak compliance by credit institutions and investment banks. Supervisory authorities found it difficult to monitor or control the corporate governance standards because there was no defined role for the supervisors. Further corporate governance failures include inadequate board oversight on risks and ineffective challenge of risk policies. The latter is caused by insufficient time spent at boards and lack of expertise by some directors. One of the options that the European Commission is considering is requiring directors of credit institutions and investment banks to have expertise. Disclosure of the skills and expertise of board members is required under the option. For the reasons given above in section 5, it is submitted that the requirements of financial expertise and commitment by board members are necessary to improve corporate governance.

The European Commission also recommended enhanced supervision and sanctions. With the former proposal, the emphasis is on micro prudential supervision. The onus is on the individual institution to prepare a supervisory programme every year on the basis of a risk assessment. The latest scandal at UBS demonstrated that rouge traders will circumvent internal controls and systems without proper supervision. On-site supervisory examinations, higher standards and more forward-looking supervisory assessments should be adopted. If a credit institution or investment bank breaches EU regulations, it is proposed that supervisors can apply sanctions. Sanctions would have a deterrent effect on credit institutions and investment banks. Sanctions could take the form of administrative fines of up to 10% of an institution's annual turnover, or temporary bans on certain board members. The financial crisis of 2007-2009 demonstrated that effective enforcement is necessary to punish the wrong-doers. So far in the UK, only two Northern Rock directors have been punished. David Baker (former chief executive) and Richard Baclay (former managing credit director) of Northern Rock were fined and banned by the FSA for hiding debt. The European Commission should therefore should regularly monitor, control and review compliance of EU regulations.

## Section 8: Conclusion

Structural reform in the form of subsidiarisation is required to improve financial stability in the UK. Full subsidiarisation is too costly and too restrictive for modern banking. The Independent Commission on Banking's Final Report is to be commended. Requiring foreign universal banks to set

up cross-border retail subsidiaries in the UK does not breach EU law as it is necessary to maintain financial stability. Article 40 of the Capital Requirements Directive needs to be amended to give host country supervisor more powers. This is necessary if we want to encourage foreign banks to provide retail banking in the UK. The EU 'passporting' regime and home country regulation are thus dated. Empirical evidence to date reveals that subsidiaries are generally well suited for retail banking due to the limited liability principle and extensive local network. The establishment of a subsidiary, rather than a branch however, does not guarantee financial stability *per se*. A subsidiary is not necessarily easier to separate from the parent company. It may rely on the parent for liquidity, support services and/or business. For subsidiarisation to function well, the subsidiaries need to be strictly independent subsidiaries with controls on intra-group operations and no reliance on the parent for funding. Directors also need to be experts in order to govern and manage risks well. Corporate governance and macro/micro regulatory aspects such as capital, liquidity and leverage ratios all play an important part in financial stability. Therefore, the Capital Requirements Directive IV is welcomed. The trio of subsidiarisation, macro/micro prudential regulation and corporate governance are all vital to maintaining a robust and stable financial system. The problem of interconnectedness should hopefully be reduced with structural reforms and the UK resolution regime. The Independent Commission on Banking recognised that time is required to implement the reforms. Banks have thus until 2019 to implement the reforms.

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