

# The Legal Structure of Ring-Fenced Bodies in the United Kingdom

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*A Response to Consultation Paper CP19/14 on the Implementation of Ring-fencing: on Legal Structure, Governance and the continuity of Services and Facilities*

*Presented by*

*Prof. Dr. Klaus Heine*  
[heine@law.eur.nl](mailto:heine@law.eur.nl)

*Enmanuel Cedeño-Brea*  
[Enmanuel.cedenobrea@edle-phd.eu](mailto:Enmanuel.cedenobrea@edle-phd.eu)

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## 1. Overview

**1.1** This paper is submitted by Prof. Dr. Klaus Heine<sup>1</sup> and Emmanuel Cedeño-Brea<sup>2</sup>, in response to the Prudential Regulatory Authority's (PRA) Consultation Paper CP19/14 on "The Implementation of Ring-fencing: consultation on legal structure, governance and the continuity of services and facilities", published on October 2014 (hereinafter, the "Consultation Paper" or "CP19/14").

**1.2** This response addresses some of the issues presented in CP19/14. In particular, it focuses on questions surrounding the legal structure of ring-fenced bodies (RFBs) in the United Kingdom (as discussed in chapter 2 and also Appendix 1 of CP19/14). However, some of the concerns discussed in this paper are also relevant for the governance of RFBs (chapter 3), as well as for the continuity of services and facilities within banking groups (chapter 4).

**1.3** This response is comprised of three additional sections. The second section, on the legal structure of RFBs, discusses that the legal organisation of the individual entities within bank groups is important for financial stability, resilience and resolvability. A third section suggests some aspects of group legal structure that could be further explored by the PRA in order to enhance resolvability. A final section questions whether ring-fencing could complicate—rather than simplify, financial supervision for home and host state supervisors.

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<sup>1</sup> Professor of Law and Economics at the Erasmus School of Law in Rotterdam. Jean Monnet Chair of Economic Analysis of European Law and research fellow at the European Research Centre for Economic and Financial Governance ([EURO-CEFG](#)), Erasmus University Rotterdam.

<sup>2</sup> Doctoral candidate (PhD) within the framework of the European Doctorate in Law and Economics (EDLE), University of Hamburg, University of Bologna and Erasmus University Rotterdam. PhD Associate at the European Research Centre for Economic and Financial Governance ([EURO-CEFG](#)). Master of Laws (LLM) in Banking Law and Financial Regulation, London School of Economics (2008). Master of Science (MSc) in Law and Finance, Queen Mary, University London (2012).

## 2. On the Legal Structure of RFBs

**2.1** CP19/14 and its proposed “Draft supervisory statement on ring-fenced bodies: legal structure”, focus on **group structure**, rather than on the legal structure of RFBs and other affiliate entities within a banking group. This is referred to in the Consultation Paper as the *“group ownership structure”* of banking groups in the UK. In addition to this group-focus, the PRA has also adopted an *“outcome”* or *“proportionate approach”* to structural and organisational issues. The legal structure of banking groups certainly is very important for enhancing resilience and resolvability. However, it is argued in this section that the legal and ownership aspects of **individual firms** (e.g. RFBs and other entities within a group) could also provide some benefits for making RFBs— and their banking groups— more resilient and resolvable.

**2.2** Some of the legal aspects of bank organisation have gained prominence after the onslaught of the financial crisis. A plethora of structural proposals for bank reform have mushroomed across leading jurisdictions, such as: the United States of America (US), Germany, France, the European Union (EU) and the United Kingdom (UK). The rising complexity of these legal and organisational issues is somewhat recognized in section 1.16. of the CP19/14, which states that the PRA will take a proportionate approach to legal structure: *“(...) given the heterogeneous nature of the firms to which ring-fencing requirements will apply (...) [and] In recognition of firms’ specific characteristics, the differing impact of the policy proposals across firms and whether the particular element of the requirement delivers the policy outcome in each case (...).”*.

**2.3** The legal structure of financial and banking groups has become increasingly large, complex and diverse. Banking groups in the UK —and in other leading financial centres—are often comprised of many different, interconnected legal entities incorporated and operating across borders. Moreover, credit institutions can also be legally organised through a wide gamut of legal forms—ranging from corporations,

different types of mutual societies and cooperatives, and even non-profit entities. It is often the case that different legal rules apply to existing organisational forms across jurisdictions.

**2.4** The legal forms that credit institutions adopt are important because each organisational form has precise combinations of legal attributes and regulations. Some of these attributes include limited liability, having a stand-alone legal personality, rules regarding residual ownership (or risk bearing) and corporate governance. Consequently, legal forms determine the underpinning ownership and governance structure for firms—including banks. Put another way, legal structures create patterns of creditors' rights (or risk/loss bearing patterns) for individual financial institutions, their banking groups and their stakeholders. These **ownership patterns** (property rights) can also be construed as incentives arrangements for different bank stakeholders, such as: depositors, residual owners and taxpayers. The aforementioned incentives are important throughout the life of a bank—but even more so, during times of financial distress and leading up to resolution.

**2.5** The ownership patterns that arise from bank legal structures also interact with deposit guarantee schemes. Depositor protection is another fundamental aspect that the PRA is calibrating alongside the legal structure of RFBs and banking groups under the present consultation process.<sup>3</sup> Like legal and organisational structure, depositor protection arrangements also modify existing patterns of ownership rights. This means that both legal structure and deposit protection schemes can exert different—and maybe even conflicting— incentives to bank stakeholders.

**2.6** Because of the importance that bank organisational structures have on stakeholders' rights, it could be advisable for the PRA to probe deeper into the granularity of legal forms for individual entities within a banking group. This would

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<sup>3</sup> Consultation Paper CP20/14 on "Depositor Protection" was also published on October 2014 as part of the Ring-Fencing Consultation.

imply going further than the expected “sibling structure” and examining which legal forms—if any—would be better suited to either: minimize the likelihood and costs of bank failure on taxpayers, or enhance the orderly resolvability of failing banks with minimum disruptions to the payments system and financial stability. There might be a trade-off which cannot be easily overcome. In its current form, the ring-fencing reform would purportedly only apply to certain large credit institutions—mainly corporations—with deposits of over GBP 25 Billion. Other important organisational forms that credit institutions take, such as mutual societies (building societies, friendly societies, industrial provident societies and EEA mutual societies) are excluded from the scope of the proposed rules.

**2.7** In conclusion, we recommend that the PRA should consider the legal structure of individual entities within banking groups—and not only the group structure itself. This could entail designing and proposing more specific, detailed and prescriptive rules for the legal organisation of RFBs and other non-core entities in the UK. Delving into the underpinnings of legal organisational forms could also shed some light into the existence of the structures that could enhance bank resolvability and resilience, minimise the external costs of bank failure and achieve greater overall financial stability. As a result, we regard more detailed ex ante rules as more effective to reach the conceived goals than the introduction of standards that have to be legally interpreted ex post.

### **3. Resolvability and Legal Structure**

**3.1** As stated in the previous section, both the group and the individual structure of banks are important for achieving resilience, resolvability and financial stability. However, the way that individual entities within a financial group are legally setup can have an effect on systemic risk containment and resolvability on a consolidated basis. This section argues that in addition to the adoption of the recommended “sibling structure”, the PRA should also consider how the legal attributes of RFBs

established as stand-alone subsidiaries could facilitate (or obstruct) group resolvability in the event of failure or distress.

**3.2** The ring-fencing proposal aims to protect deposits and other core activities by spinning off such activities into separate legal entities. While the PRA has not prescribed a specific form for organising RFBs, it is likely that such entities will be structured as corporations. Limited liability (also called “owner shielding”) and legal personality (“entity shielding”) are two of the flagship attributes that corporations have. These attributes have been recognized in the academic literature to have important legal and economic consequences.

**3.3** Establishing RFBs as standalone legal entities implies that their assets would be shielded from the failure of other group entities. This is one of the objectives that bank ring-fencing purports to achieve. However, limited liability could hinder this objective in the event of the insolvency or financial distress of a RFB. Limited liability implies that holding companies do not have an obligation to capitalize RFBs in the event that the later fail. Instead, the proposed rules intend to enhance resolvability by promoting bail-ins at the group level. Insofar it might be advisable to think in more depth about an effective way of “piercing the veil” in case of financial distress of a RFB.

**3.4** In addition to the adoption of the “sibling structure” and bail-in at group level, the proposed rules for enhancing the resolvability of both banking groups and RFBs could benefit from: (a) requiring holding companies to act as a “source of strength” to their RFBs<sup>4</sup>; (b) corporate veil-piercing and legal personality piercing for holding companies and other affiliate entities within a banking group. In the event of insolvency or financial distress of RFBs, this approach would allow regulators and

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<sup>4</sup> Following the US model, as originally established in § 225.28 of the Bank Holding Company Act of 1957 and Regulation “Y”. “Source of strength” is interpreted to mean: *“The ability of a company that directly or indirectly owns or controls an insured depository institution to provide financial assistance to such insured depository institution in the event of the financial distress of the insured depository institution”*.

supervisors to tap into capital and liquidity available in other parts of the groups structure—not only limited to the UK holding company. In addition, having the option to pierce the corporate veil will already set a strong incentive for a proper behaviour of holding companies.

#### **4. Could Ring-fencing Complicate Supervision?**

**4.1** Could Ring-fencing complicate— rather than simplify, group structure? In turn, could it make supervision more difficult for both home and host state supervisors? This section argues that the proposed rules could generate difficulties for financial supervisors. Such complications include moral hazard and coordination problems.

**4.2** Ring-fencing through subsidiarisation is likely to increase the number of legal entities under supervision in the UK. Many cross-border banking groups already have convoluted and multilayered legal and organisational structures. Adding additional entities into the mix could increase supervisory challenges and exacerbate information asymmetries.

**4.3** The argument that ring-fencing could make supervision more difficult challenges the idea, presented in the Vickers Report, that: *“removing the complexity of some wholesale/investment banking would make it easier for ring-fenced banks to be managed, monitored and supervised”*.<sup>5</sup> According to the Vickers Report, the simplification process would purportedly also enhance resolvability. However, by increasing the number of supervisees, oversight could be diffused, becoming ineffective when and where it matters the most. Consequently, opportunities for malfeasance and human error could proliferate. Taking this into account underpins the argument for clear and detailed ex ante rules instead of the application of standards that have to be adapted to special cases ex post.

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<sup>5</sup> Independent Commission on Banking, Final Report, p. 46.

**4.4** Moreover, Ring-fencing coupled with deposit protection insurance schemes can potentially generate moral hazard and biases for bank regulators. Regulators and supervisors could become overconfident by trusting that—thanks to a combination of ring-fencing and deposit protection insurance schemes—depositors will not lose their money and taxpayers would not need to bailout banks in the event of failure. This can lead to the reduction of oversight efforts. Ring-fencing could also give supervisors an illusion of having greater control over RFBs, motivating them to concentrate more efforts in the supervision of ring-fenced entities, while losing sight of other—often riskier—trading entities within a banking group, that fall outside of the fence.

**4.5** The moral hazard problem discussed before could also generate coordination problems between home and host state supervisors. In particular, coordination problems can arise when the host state that adopts deposit ring-fencing is also the home state of important financial groups that conduct activities abroad. This is the case of the UK—a global banking powerhouse—with the potential to export externalities overseas. Four British banks are currently in the Financial Stability Board's (FSB) 2013 list of Global Systemically Important Banks (G-SIBs).

**4.6** If home states for large banking groups, like the UK, reduce the monitoring efforts of their own banking groups in order to concentrate on supervising their local RFBs, coordination problems could ensue. For example, host states to British could experience heightened coordination problems, information asymmetries, and potential negative externalities locally. Moreover, host states to British G-SIBs could also feel inclined to enter a *race-to-the-top* by adopting similar deposit ring-fencing measures in an attempt to protect their local depositors and mitigate the potential importation of negative externalities from operations abroad. Should more financial supervisors focus their oversight on protecting local deposits, a larger—and riskier part of bank activities could be left

unsupervised. Thus, the dynamics of the proposed regulation should be taken into account, especially for the background of regulatory competition.