ELECTRIC SHOCK

Ring-fencing will transform the international banking landscape and undoubtedly present some unwelcome complications for treasurers, says Alex Hawkes

To ring-fence, or not to ring-fence? That, for large-company treasurers at least, will soon be the question. Should you place company deposits with a wholly retail bank or, alternatively, opt for a wholesale investment bank option?

This is one of the dilemmas that will be thrown up by ring-fencing, and it is not easy to decide. Whatever option they plump for, treasurers will undoubtedly find themselves much busier in a ring-fenced world, managing banking relationships fractured by regulation. For starters, it is far from clear which kinds of banks will be able to offer derivatives, and whether they will be affordable and as available as they have been. Treasurers will also have to understand the complications of other international ring-fencing initiatives when structuring their global banking operations and financing subsidiaries. They may have to reassess how they manage risk; and in the direst instances, some warn that the moves could roll back the tide of globalisation when it comes to financing corporate activity.

Ring-fenced banking – the mooted solution to the financial crisis and the way to stop governments being on the hook for the banking system – could be a reality by 2019. In February, the UK government introduced its Financial Services (Banking Reform) Bill, which many expect to gain royal assent by the end of the year. The Bill sketches out the basics, says Gregg Beechey, partner in the financial institutions group at international law firm SJ Berwin: "At the moment, the only activity that has to be in the ring-fence is retail deposit taking. The only thing that can't be is dealing as principal [proprietary trading]." Secondary legislation and regulatory rules from the new Prudential Regulatory Authority will, in due course, set out the nuts and bolts of a ring-fence.

The Vickers vision

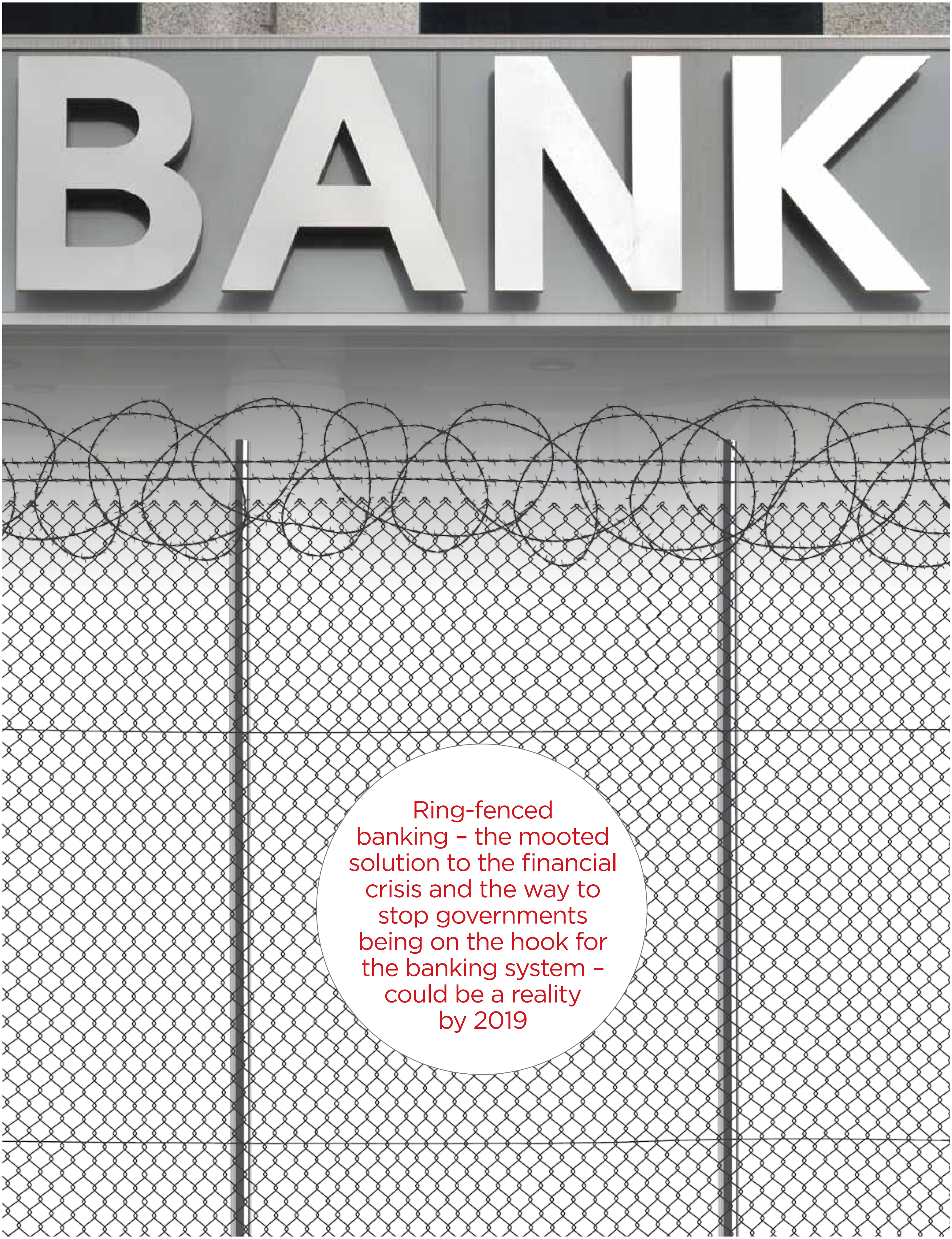
The vision of Sir John Vickers, chair of the Independent Commission on Banking (ICB), is that a ring-fenced bank will be the only kind of institution able to provide deposits and overdrafts to individuals and SMEs. It will not be able to offer anything that is 'not integral to payment services or intermediation in the European Economic Area'; anything that exposes the ring-fenced bank to the global markets; or anything that could complicate its unwinding, including 'services to non-EEA customers, services (other than payment services) resulting in exposure to financial customers, "trading book" activities, services relating to secondary markets activity (including the purchases of loans or securities), and derivatives trading (except as necessary for the retail bank prudently to manage its own risk)'. A ring-fenced bank is likely to be permitted to offer deposit taking and loans to high-net-worth individuals and companies, but that will not be a 'mandated' activity that is confined within the ring-fence – those individuals and companies will be able to go elsewhere for their banking.

So, where would you place your deposits? The question is one that even Vickers did not have a definitive answer to. A ring-fenced bank might, for various reasons, be perceived as safer. But, as he put it, "a corporate deposit would bear losses before retail depositors, meaning that they would suffer a higher proportion of any losses that did occur if they deposited in a ring-fenced bank rather than a non-ring-fenced bank."

John Grout, policy and technical director at the ACT, says: "The question is: would you prefer to be in the risky side of the bank, a normal creditor of the risky side or a creditor of the 'non-risky' side who is put behind all the insured depositors?"

It is by no means clear, and treasurers will make decisions on a number of factors, not least the interest rates offered by different banking models. Treasurers will be doing "credit evaluations on banks at all times", according to Giles Williams, a partner and head of the European Centre for Regulation at KPMG.

The Independent Commission on Banking's review is meant to make banks safer, easier to resolve in a crisis and ultimately ensure that the government will not have to bail them out.



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RING-FENCING AROUND THE GLOBE

Another key question of a new ring-fenced banking world will be: whose ring-fence?

"If you are a treasurer of a multinational, one needs to be cognisant of various ring-fencing proposals. If you look at purely UK and Vickers' proposals, there's a danger you miss what is going on in the US. The French, Germans and Swiss are also effectively going down a ring-fencing route," Giles Williams says.

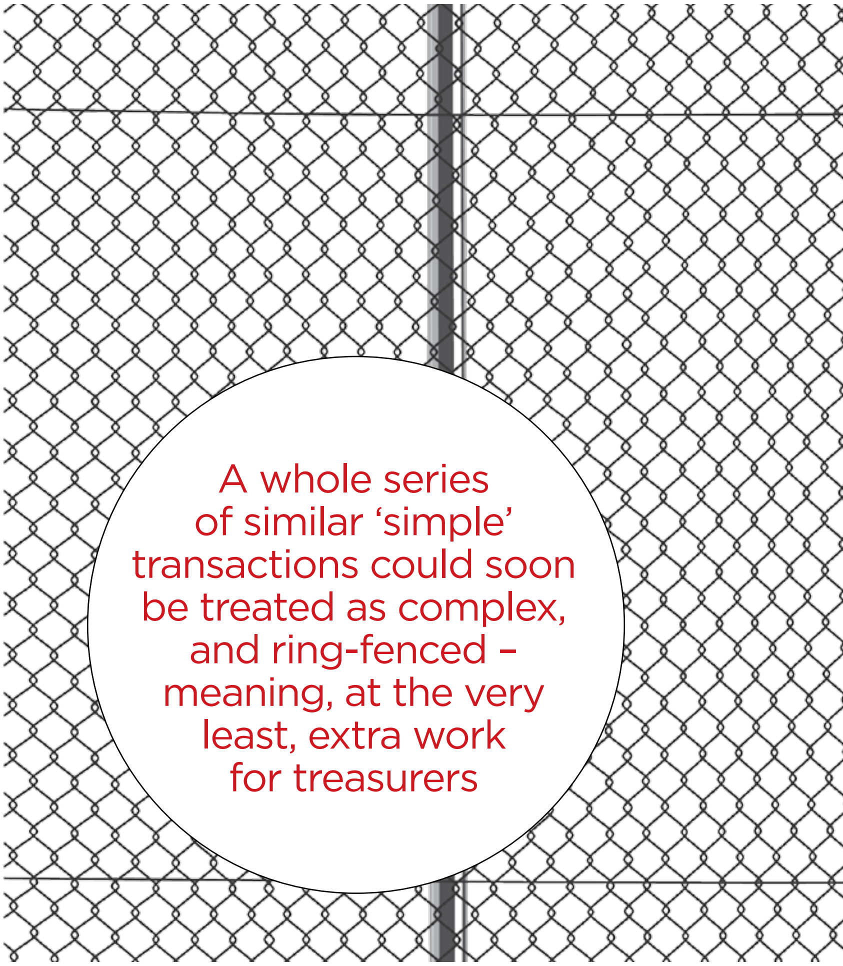
The biggest plans around the world are the EU's Liikanen plans, which Vickers has himself likened to a mirror image of his proposals as they entail ring-fencing banks' investment activities rather than their retail arms; and the Volcker Rule, which prohibits US banks from being involved in any way with proprietary trading.

Williams adds: "If you do business with the big French banks, there is talk they might do a Volcker approach. For your French subsidiaries using a French bank for accounts payable, you might, all of a sudden, find that derivatives will be pushed out to a separate subsidiary. In the UK, you might probably be able to do some derivatives for hedging purposes, but it may be in France you can't do that. If you are running an integrated treasury and do some business with French banks through branches in London, which rules would apply?"

In the US, meanwhile, there are plans to ensure that foreign banks operating there are set up within limited companies and separately capitalised. "That will probably mean the ability to run some of those businesses as part of integrated global divisions will become more difficult. If they are foreign banks there and your main bank is here, what is that going to mean in terms of running one banking relationship? It becomes a geographical ring-fence," Williams argues.

The deeper fear here is that some of the benefits of globalisation – of large companies being able to centralise their capital for all their needs and put it to work effectively – will be unwound by banking rules that require different pots of capital to be in different places, and within different parts of banking groups, to satisfy the banks' regulatory requirements.

John Grout approaches the same problem from a different direction, outlining the example of a company borrowing cash through US private placement bond markets to finance a factory. Instead of undertaking a long-term currency swap and building the factory elsewhere, it might make more sense to build the factory in America, to manage the risks in paying back the bond. "If derivatives become more difficult, you deal with the risk in a different way," he says.



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"Analyst estimates relevant to the package of reforms proposed suggest that the annual pre-tax cost for the major UK banks could be from £2bn up to £10bn, with an average estimate of around £6bn, equivalent to 0.1% of the funded assets of the largest UK banks," Vickers wrote. If costs were passed on, Vickers suggested banking spreads might increase by 0.1%, either making lending a little dearer or depositing cash a little less remunerative.

The GDP effects of that increase in spreads, he said, were negligible – and hugely outweighed by the financial stability benefits. Governments would no longer implicitly support banks, and banks, being better capitalised, would attract a lower cost of capital. If true, that would be great news for companies as the result would be stronger banking partners with less of a 'casino' culture.

Doubt over derivatives

But the moves will undoubtedly fundamentally change the service treasurers receive. One of the biggest cans of worms is whether or not a ring-fenced bank can offer derivatives. That could mean products, such as equipment leasing, provision of trade finance, guarantees and letters of credit, and FX swaps, could all be separated from small companies' everyday banking. The government, breaking ranks with Vickers, is proposing that 'simple derivatives' could come within the ring-fence. The rules on what constitutes a simple derivative, however, are "as clear as mud", according to Grout.

Although HM Treasury has described hedging FX risks as an example of a simple derivative, it also says in the same breath that derivatives that cannot be easily valued according to market prices are not simple. "Locking into forward FX rates is not

MIXING WITH METAPHORS

Among other things, those involved in the bank ring-fencing debate have delighted in extending the metaphor of the 'ring-fence' in various ways.

Vickers himself discussed in his report the 'height' of the ring-fence. That is code for the extent to which the same group could own a retail and a wholesale bank. Vickers felt that they could, to benefit from the advantages of cross-subsidy and synergies, although he was dismissive as to whether there were any great synergies.

The Parliamentary Commission on Banking, meanwhile, has introduced the question of whether the ring-fence should be 'electrified'. All that means, in reality, is that there will be someone to monitor it to make sure the banks are not abusing the new rules.

'standardised' since a quoted market does not exist, but this is nonetheless a very standard product, meaning a normal and common transaction done by companies to manage business risk from importing or exporting," the ACT said in its response to the banking White Paper. A whole series of similar 'simple' transactions could soon be treated as complex, and ring-fenced – meaning, at the very least, extra work for treasurers.

"The experience is that, historically, different bits of banks, different vertical silos, have been very bad at talking to each other. Already we are seeing that effect magnified as the British banks begin to organise themselves into a ring-fenced structure. Companies are having to manage banking relationships, with the overall relationship managers being less effective. If you want something to go on in Spain you need to know who can deliver it. In the past, you could just kick your man in London," says Grout.

The pricing is likely to change, too. Currently, banks price for the relationship; loans and deposit taking are subsidised by higher-margin ancillaries, such as advice and hedging products. The former could get more expensive while the latter could get cheaper.

Grout envisages a further situation where a wholesale bank might want a company to put cash on deposit with them as collateral on a derivative. Could that cash come from another bank's loan? "The banks in the ring-fence will say that's not what we gave you money for."

Those sorts of problems, Williams says, will mean difficulties for treasurers in managing working capital and offsetting balances. "There are costs of that, which will feed on to your end users."

These more complex relationships might be manageable for large organisations, but will be tough for SMEs. Grout says: "If you are sufficiently large for the other part of the bank to understand you and recognise you are worthwhile doing business with, then it may not be a problem. If you are a smallish, mid-sized company, the investment side of a bank is likely to say: Even if we like the credit standing, they will not reward the time it will take us."

Whether or not derivatives will ultimately be allowed within ring-fenced banks, meanwhile, is still a matter of fierce debate.

Martin Taylor, the ex-chief executive of Barclays and a former member of the ICB, told the Parliamentary Commission on Banking: "I can't see the point of having a fence round the chicken coop, electrifying it to keep the foxes out and then inviting a family of tame foxes to live inside it."

Given the scale of the financial crisis, and the state bailouts that followed, few are prepared currently to question Vickers' reforms in any meaningful way. But as its memory fades and the full impact of Vickers becomes clear, treasurers might start to wonder if the solution to the crisis doesn't present some pretty tricky problems of its own.

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