Five things borrowers should know about bank ring-fencing

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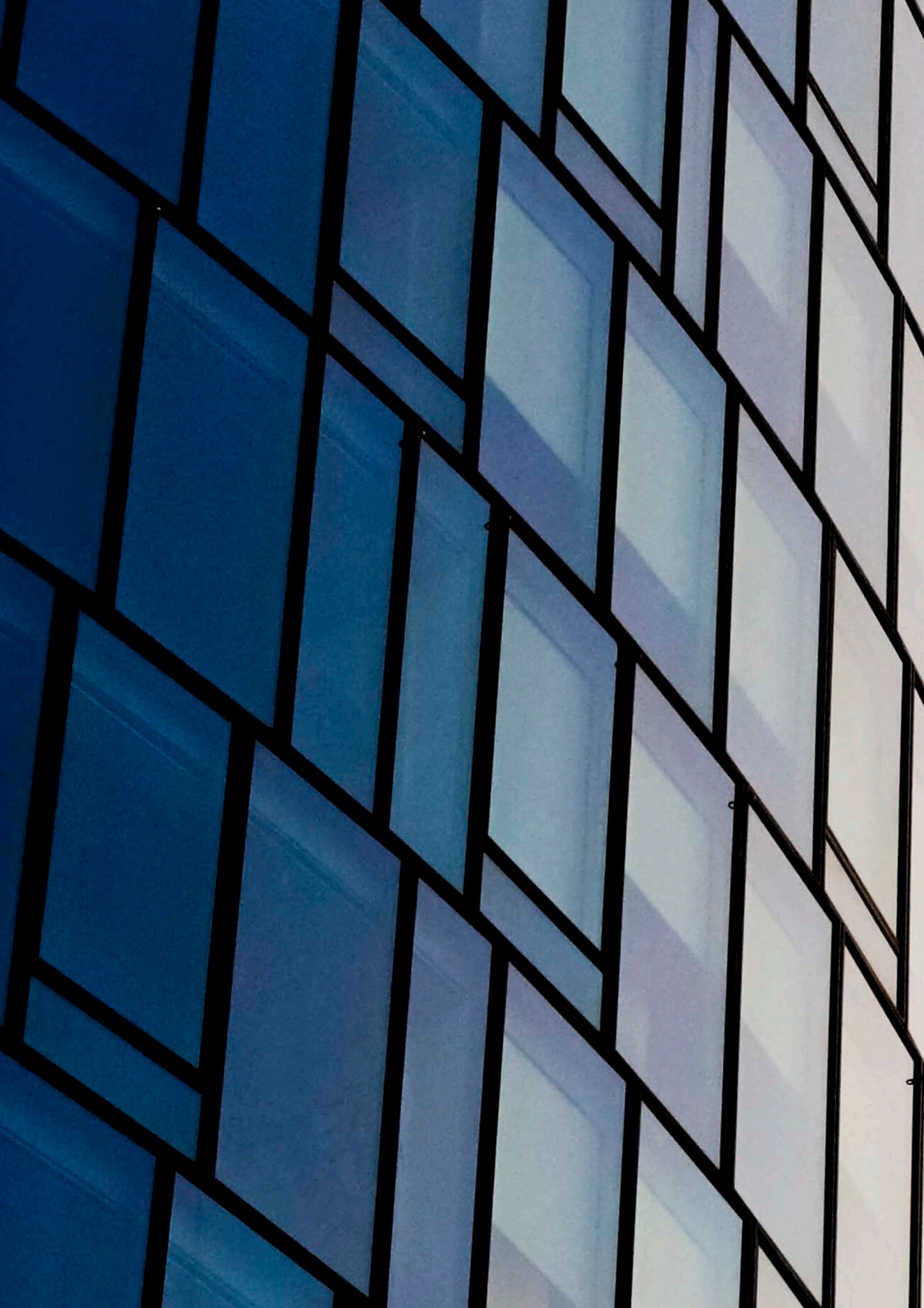


KPMG highlights key areas borrowers should focus on through the ring-fencing reform.

As has been widely reported, under the bank ring-fencing reform, from 1 January 2019, the largest UK banks (those with over £25 billion of UK deposits) must have separated their investment banking services from their core retail banking offering. The impacted institutions are in the process of finalising their respective new structures, each comprising a ring-fenced bank (RFB) and a non ring-fenced bank (NRFB).

Outside of some strict requirements, these institutions must choose which customers and which product offerings will sit inside or outside the ring-fence. This decision will impact borrowers now and in the future.

Of course, banks are no longer the sole source of debt funding to corporate UK - with the growth of debt capital markets and alternative direct lenders. However, banks remain at the heart of providing liquidity to UK businesses, particularly for smaller companies, so we think understanding and preparing for the impact of ring-fencing should be a priority.

In this guide, we highlight five areas that borrowers should know about in the face of this regulatory shift.

1. Your banks may now have very divergent priorities

The regulations and legislation regarding UK bank ring fencing do not provide explicit guidance covering every bank activity or customer type and whether these need to sit inside or outside the ring fence.

In very simple terms there are some rules that the banks impacted will have to adhere to:

UK deposits from individuals and small businesses need to sit within the RFB.

Most trading activities and exposures to financial institutions need to sit outside the ring fence in the NRFB.

Certain other activities may be either inside or outside of the ring fence (e.g. banking for larger companies).

This discretion over final structures has led to a variety of interpretations, with some opting for a narrow definition of what is placed inside the ring fence and others taking a broader view.

2. Cost is increasing for some borrowers

The initial costs of the RFBs and NRFBs is significant, with figures running into several hundred million pounds for each bank. The introduction of additional risk buffers at the same time as the ring-fencing reform will add further capital requirements for UK banks. We believe these factors have to feed through to higher pricing for borrowers.

The split into two banks means two sets of capital and losing the benefit of diversification between investment and retail banking. The NRFB will naturally be deemed more risky once the simple operations are stripped away. The NRFBs will therefore have to hold even greater capital and liquidity buffers against the loans they issue and pay a higher rate of interest to the market for deposits and borrowings.

Keeping cash aside for emergencies is good practice but it also means banks have to raise a lot of money that can't be lent back out or invested. It comes at an opportunity cost which will be keenly felt by corporate borrowers.

Finally, some banks still offer loans at a lower margin in order to build relationships and gain business' long-term custom which both the retail and investment arms will benefit from over time. Whilst a lot has already been done to cut down on this practice, under ring-fencing any potential benefit of cross subsidisation will be lost. Corporate loans will need to be profitable in their own right.

Over the last 12 months or so, we have seen banks pre-emptively pushing for significantly improved returns to continue lending (through pricing increases and/or additional ancillary income) or simply exiting lending relationships (even mid-term) as the economics no longer work for them.

3. International banks will be the winners

There is evidence of UK banks walking away from lending relationships over the last year or so. Particularly in a post EU referendum world this is a concerning turn of events for UK borrowers. However, non-UK lenders are actually well positioned and showing real demand to pick up any slack created by a lack of liquidity from the UK.

It was announced in late 2017 that European banks would no longer need to go through a similar ring-fencing process. This has generally been seen as a negative development for the impacted UK banks given the additional capital they will need to hold relative to their European peers who can also still use their substantial deposit bases to fund lending.

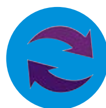
At a point when these European banks, alongside peers from the US and Asia, are increasingly active in the UK market, the bank ring-fencing regulations may well provide them with an advantage they will happily exploit to help gain UK market share.

However, it would be remiss not to recall the general retrenching by international bank lenders in the UK market in the period following the credit crunch and therefore the possibility that any downturn or hard Brexit arises could see this happen again.

4. Your bank relationships may be up for change

An additional impact of the reform is uncertainty regarding a borrower's relationships within its lenders. A certain borrower may well have a Relationship Director who has been its main point of contact for many years, understands the business and has an ability to position appropriately the credit with decision makers, to both parties' benefit.

Will there be an enforced change in Relationship Director from day one for certain borrowers?



If not the case straight away, is there a risk of a change eventually being made alongside the likely initial flux after the reformed structures are in place?

Will the banks approach this on a consistent basis or will borrower treatment vary amongst peers?

The answers are not clear currently. However, in a world where relationship sustainability may be harder, a breadth of relationships may be key for borrowers to ensure they can access required funding going forward.

5. Weakening of cross-selling – finally less focus on the ancillary wallet?

There is a lack of clarity regarding the provision of other services by the banks following the reform being implemented. While each bank is putting 'cross-bank' servicing in place and messaging is predominantly that it will be "business as usual", it is unknown how well these will actually perform in practice and if there will be any resulting dislocation.

As noted above, whereas historically there would have been reward and therefore incentive for both the Relationship Director and their Investment Banking colleague for selling/providing a service such as hedging, will this cross-selling be diminished if these parties potentially sit in different entities? In our experience, effective cross selling is a very personal and financially motivated endeavour. The banks' ability to motivate relationship holders to cross-sell in the new structure will be an interesting challenge.

It will take some time for the banks to settle into their new structures. Therefore, it may not be clear straight away if there will be a significant impact on cross selling, or the number of products offered/pushed, or even if banks will become comfortable with borrowers going to third parties for a particular product if this is not provided by the entity providing the loan.

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