Knowledge Sharing Scotland – 21 May 2015

The 3 Rs: Risk, Regulation and Ring-fencing

Navigating the pensions maze at UK banks

Doug Baird and Sharon Midwinter

Agenda

- Typical current pensions agenda for a bank
- Purpose of banks
- Focus on banking capital requirements
  - Banking capital overview
  - Pension impact on capital resources
  - Impact on pension strategy
- Focus on banking reform
  - Background
  - Pensions specific requirements of banking reform
- Linking it all together

Typical pensions agenda for a UK bank

Capital management

P&L	Risk	Cash

Governance

Journey planning

Scheme Funding

ICB/ringfencing

Business restructuring

Freedom and choice

PPF levy management

Liability/risk management

Employee engagement

Cessation of contracting out

Banking capital example – a Bank Balance Sheet with no DB pension scheme

Why do Banks exist?

- Provide payment services
- Provide credit to households and businesses
- Risk management services: e.g. current accounts to personal customers, issuing debt securities

Assets (use of funds)	**Liabilities and capital (source of funds)**
Cash and liquid assets - 10	Retail deposits and wholesale funding- 85
Loans - 90	Ordinary shares and Reserves - 15

Capital is a form of bank funding that can absorb losses

Bank capital requirements - the ‘3 pillar’ approach

Basic principle

Capital resources > capital requirements

Pillar 1

Minimum Capital Requirements

Pensions: IAS 19 impact

Pillar 2

Supervisory Review Process

Pensions: ‘1 in 200’ 1 year stress

Pillar 3

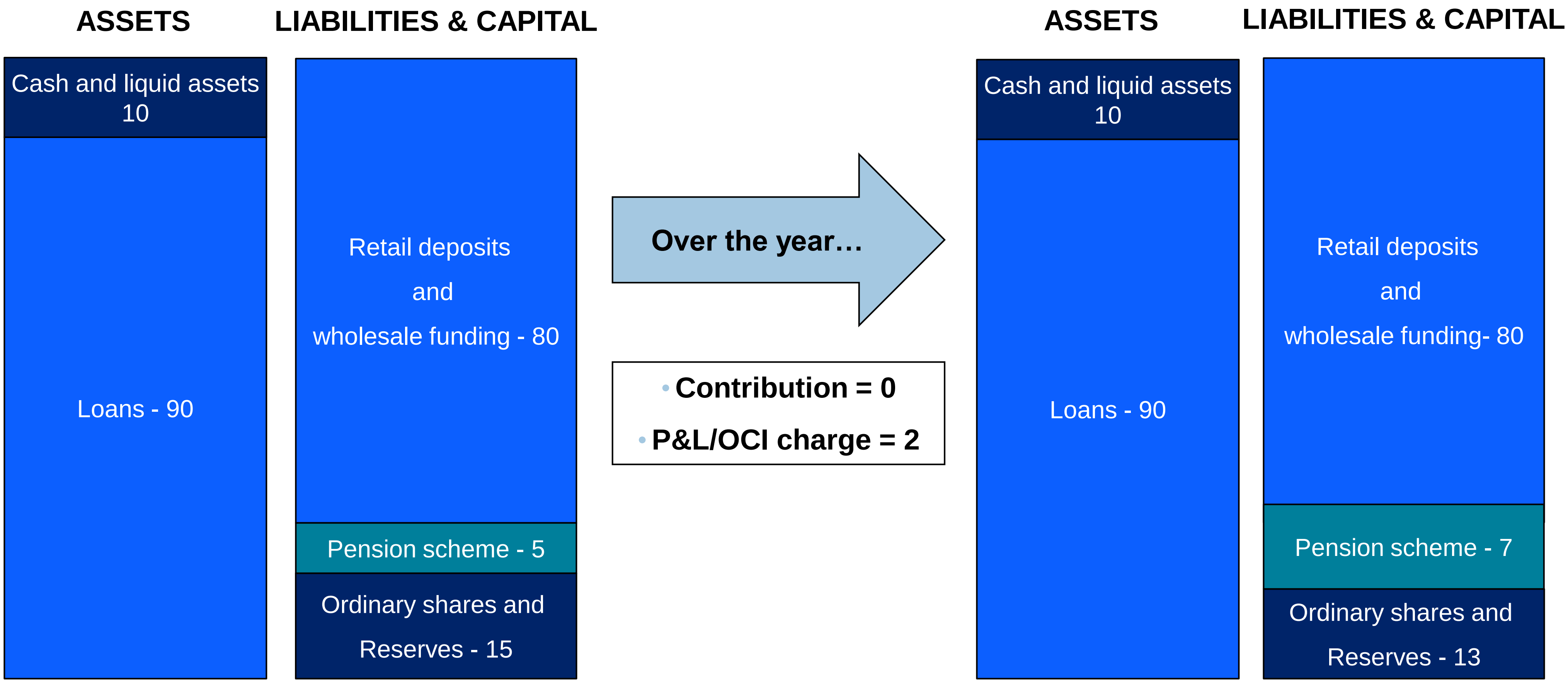
Market Discipline

Pensions: Pension risk notes

Banking capital example – with DB scheme in IAS 19 deficit

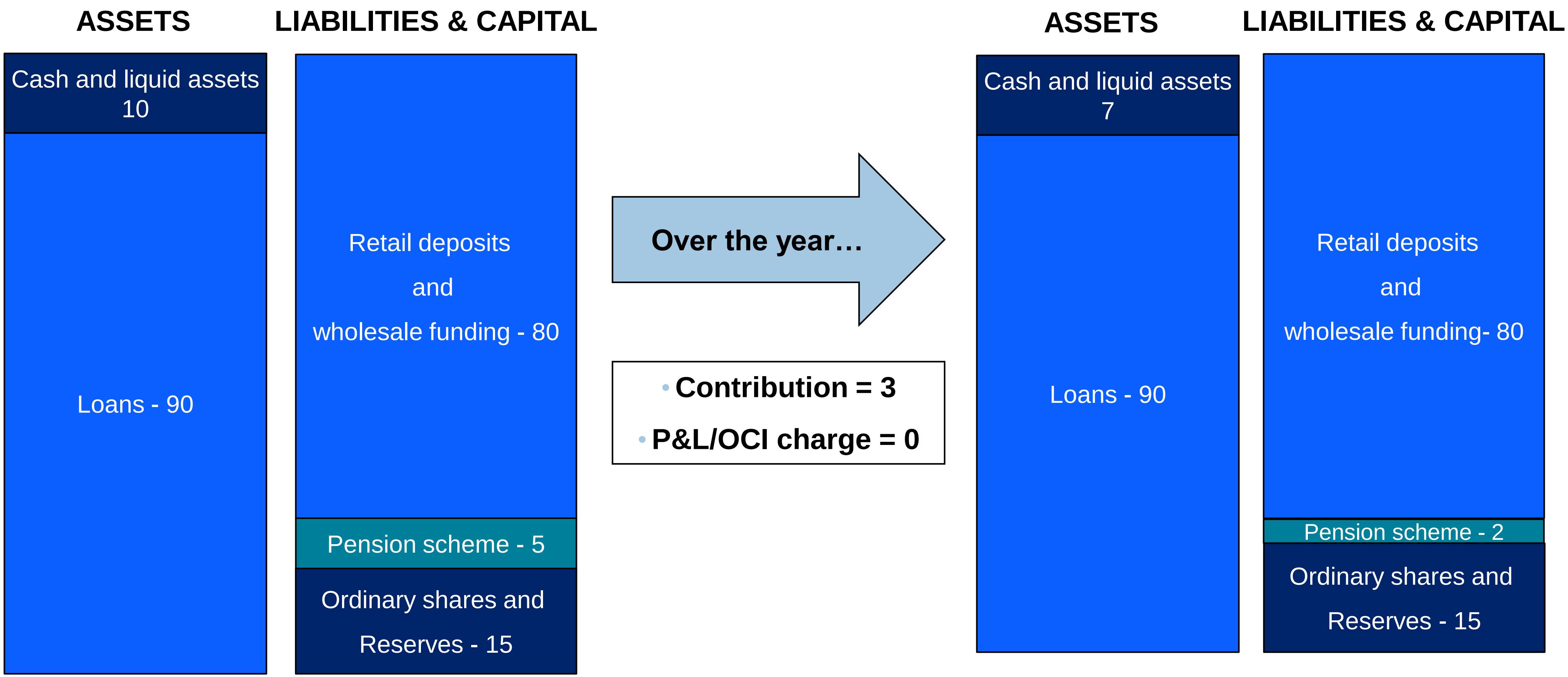
- Pension losses (gains) reduce (increase) shareholder reserves
- This flows through to the capital resources of the bank
- Managing the IAS19 position can lead to conflicts with the trustee's objectives

Banking capital example – pension gains (losses) in IAS19 deficit



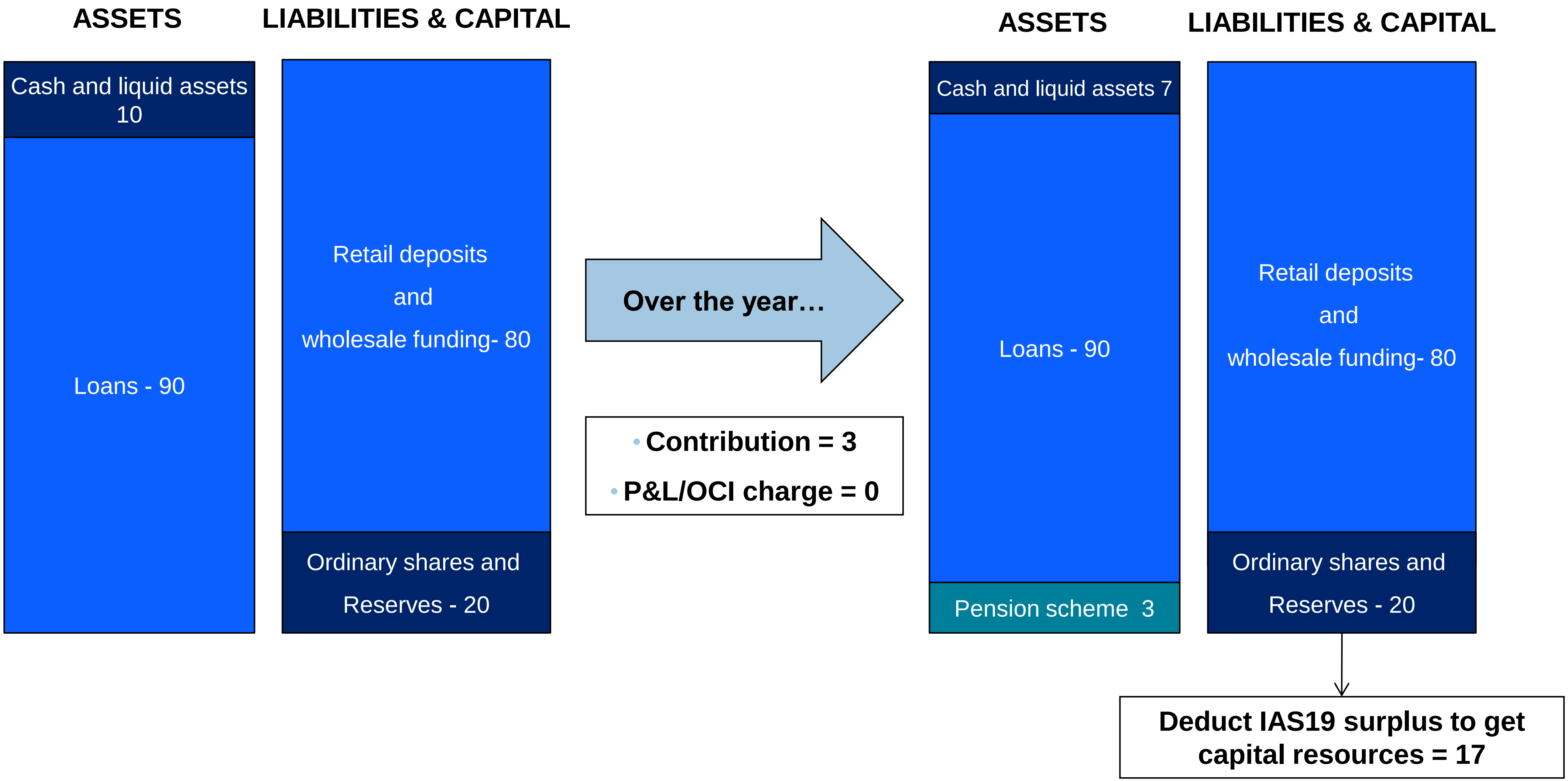
Pension gains (losses) increase (reduce) capital resources when in IAS19 deficit

Banking capital example – cash contributions in IAS 19 deficit



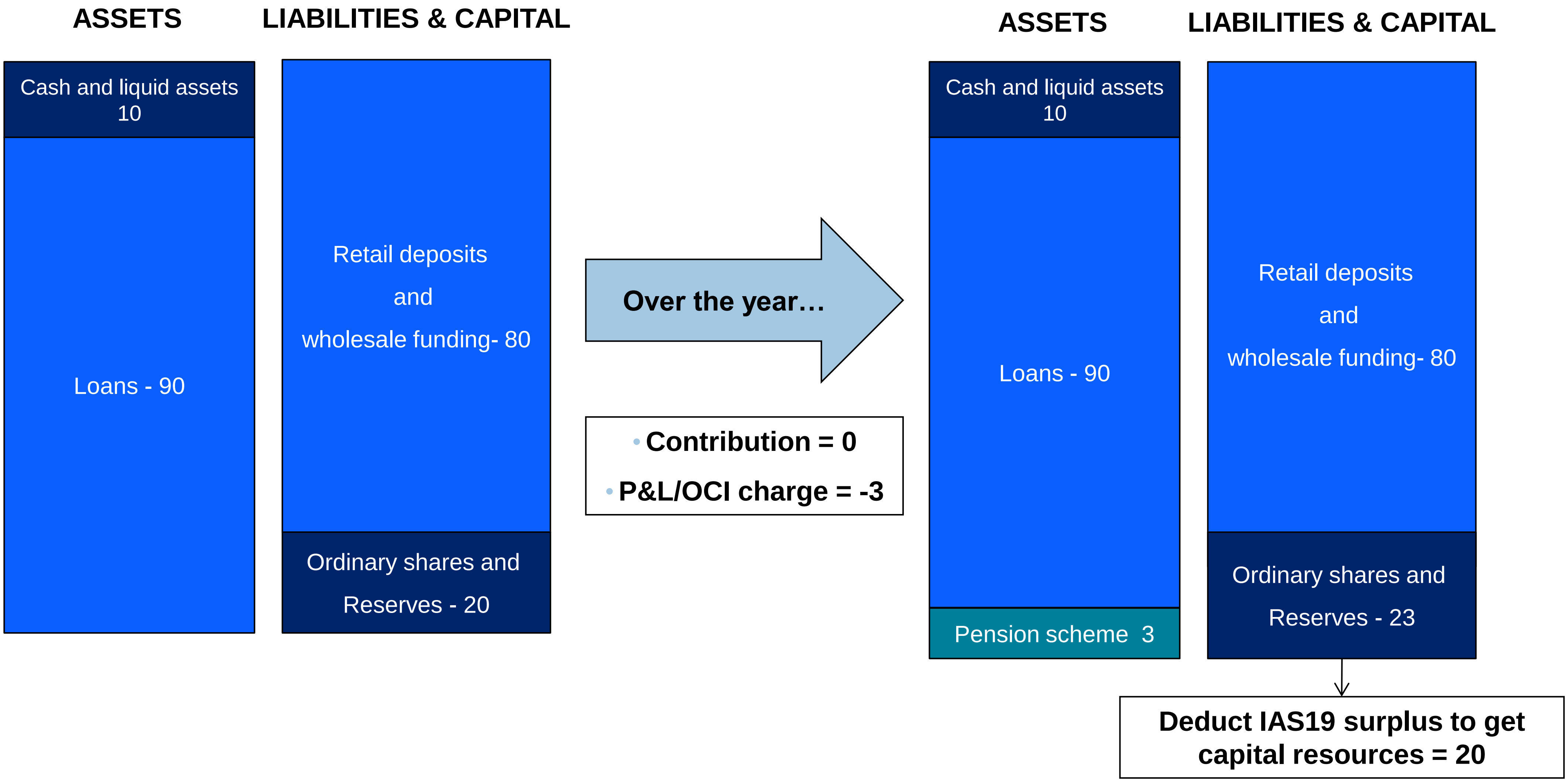
Cash into an IAS19 deficit is capital neutral

Banking capital example – cash contributions in IAS 19 surplus



Cash into an IAS19 surplus is capital erosive

Banking capital example – pension gain/loss in IAS 19 surplus



Pension losses/gains are capital neutral when in IAS19 surplus

Pillar 2 – Pension risk

'The risk to a bank caused by its contractual liabilities to a pension scheme…'

1 in 200 stress − **Management actions** − **IAS19 deficit** = **Pillar 2**

PRA consultation on Pillar 2 - new rules due to come into force on 1 January 2016

- 2 stressed IAS 19 scenarios to benchmark Bank's own internal assessment of P2 capital
- Justify changes in IAS 19 assumptions
- Decomposition of IAS 19 discount rate

- Section 75 debt information
- Details of any SPV/Escrow arrangements
- Provide details of duration
- More granular detail on assets

Implications for pension funding

What is ICB?

"Ultimately, financial risks have to be borne, and in a market system they should not be borne by the taxpayer providing a generous safety net…Credible resolution would seem to require at least some form of separability, and arguably there is a case for some form of ex ante separation…"

Sir John Vickers, Chairman of ICB, January 2011

- **Independent Commission on Banking** established in June 2010
- Aim is to promote financial stability and competition in the wake of the financial crisis of 2007–08
- Chaired by John Vickers, including representatives seconded from HM Treasury, the Department for Business, Innovation and Skills, the Financial Services Authority, the Bank of England and the Office of Fair Trading.
- Produced final report and recommendations to the UK government on **12 September 2011.**

Headline recommendation was that British banks should 'ring-fence' their retail banking divisions from their investment banking arms to safeguard against riskier banking activities

- Made a number of other recommendations on bank capital requirements and competition in retail banking.

What form does the legislation take?

The Financial Services (Banking Reform) Act received royal assent on 18th December 2013. It will bring into law structural and cultural changes to the banking system by:

- Requiring that **banks ring-fence the deposits of individuals and small businesses**, separating important everyday banking activities from investment banking
- Making sure the **PRA can hold banks to account** for the way they separate their retail and investment activities, giving it powers to enforce the full separation of individual banks
- Imposing **higher standards of conduct** on the banking industry by introducing a criminal sanction for reckless misconduct that leads to bank failure
- Giving **depositors preference** if a bank enters insolvency
- Giving the **Government power to ensure that banks are more able to absorb losses**

What does the Act focus upon?

Three key dimensions:

- **Location of Ring-fence**
  What activities must be included in or excluded from a Ring-Fenced Bank (RFB)?
  What permitted customer types, products and/or geographies should be included to create viable banks on either side of the ring-fence?

- **Height of Ring-fence**
  What level of separation does the legislation require between RFB Bank and Non Ring-fenced Bank (NRFB)? Covers Operations, Governance, Resolvability and Risk of Contagion

- **Electrification of Ring-fence**
  What powers of enforcement should the regulator / government possess, and with what checks and balances?

Summary of Current ring-fence Rules

2019

Critical banking functions should be ring-fenced by 1st January 2019 to improve the ability to resolve a failing bank and to reduce the risk of contagion from investment banking to retail and SME activities.

Customers

- UK Retails and SME deposits MUST be in RFB
- Any other customer can choose to deposit in RFB
- Some customers can choose to deposit in NRFB

Products

- Deposits and overdrafts of UK Retail/SME customers must be in RFB
- Specific list of products excluded from RFB – e.g. non-vanilla derivatives, international cash management outside EEA

Geography

- Branches/subsidiaries outside EEA **must** be outside RFB
- Exception if non-banking (e.g. Op-Co)

Operational independence

- Governance, risk management, HR and remuneration decisions for RFB must be taken independently of NRFB
- Limitation on RFB ownership

Exposure to contagion

- RFB must be able to carry on core activities if NRFB or another RFB fails
- RFB must not rely on resources of NRFB

Much detail remains to be completed (by the PRA), which will define the rules on governance, operational separation and intra-group transactions as well as future reporting requirements.

ICB and Pensions

2026

RFB and NRFB cannot be participating employers in the same multi-employer scheme post 2026

A ring-fenced body must not be an employer in respect of a multi-employer scheme unless:

- The only other employers are RFBs; or
- The other employers are wholly-owned subsidiaries of ring-fenced banks

Clearance

- Ring-fencing related restructuring
- Material detriment?

Covenant

- Scheme backed by fewer employers
- Depositor preference

Section 75

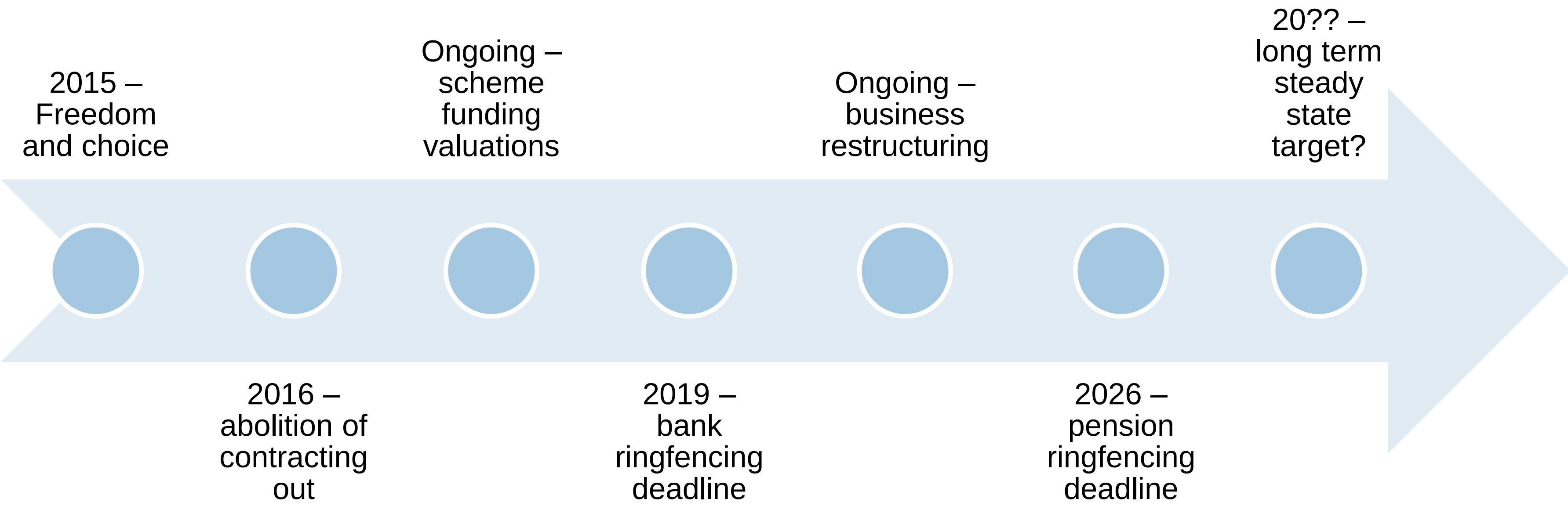
- Employment cessation events
- Trigger points?

Classification: Confidential

Linking it all together

Capital management

P&L	Risk	Cash



Governance

Trustee engagement	Employee engagement	Board management

Questions?