intellect
REPRESENTING THE UK TECHNOLOGY INDUSTRY

Beyond a retail banking ring-fence – the once-in-a-generation opportunity to fix the financial system

July 2011

< Previous page

> Next page

Executive Summary

The purpose of this paper is to set out the views of the technology industry on the issue of a retail banking ring-fence, one of the key considerations under review by the Independent Commission on Banking (ICB). Intellect's members provide the fundamentally important technology platforms upon which the UK's financial services industry is built, and are well placed to offer views on whether the ring-fence is the best 'tool for the job', what other issues the ICB may want to look at, and the wide ranging implications of implementing a ring-fence.

The ICB's review is just one of a number of regulatory reform initiatives currently being undertaken, both in the UK and across the global financial system, in response to the financial crisis. It is important that the ICB bears these in mind when making its final recommendations, and is wary of making decisions based on political imperatives rather than the realities of the financial system.

The main findings and recommendations within this report are as follows:

Retail banking ring-fence – the right tool for the job?

- A retail ring-fence is not a silver bullet that will ensure the stability of the UK's economy on its own. It should be the last line of defence within the financial system, not on the front line. If the ICB recommends a ring-fence, it should complement other regulatory reform initiatives that are currently being implemented rather than trying to duplicate the same outcomes
- Intellect's members believe that the same result, i.e. a retail banking division which will continue to provide critical economic services, may be achieved under current reform initiatives (such as Living Wills) and the implementation of better risk analytics and data within banks
- The ICB should examine the disaster recovery strategies already in place within banks which essentially seek to achieve the same thing. A ring-fence could form part of a bank's existing disaster recovery strategy
- However, the ICB has yet to provide a definition of a ring-fence. It is significantly harder to determine what the possibilities, challenges and issues around a ring-fence are, when the concept has not been sufficiently defined

Operational challenges of implementing a ring-fence

- The ring-fence will be complex, time consuming and potentially expensive to implement as a result of the complex and intertwined IT systems within banks. The bank will also have to consider people and processes alongside the technology. The scale of the task will depend upon the bank, its unique operations and what products/services each chooses to place in the ring-fence
- A retail banking ring-fence is a measure of last resort against financial instability. It has to ensure that crucial economic services provided by the bank continue in the event of a failure of the non-ring-fenced division. The people, processes and technology that underpin these crucial economic services must therefore be separated and prepared in advance of any such failure, so that they may function in a stand-alone retail bank
- All banks will start implementing a ring-fence from a different position. Therefore The ICB will need to prescribe minimum scenario-based outcomes to ensure that crucial economic services are built into the ring-fence
- However, the ICB will need to mandate the systems changes necessary for banks to implement a ring-fence, in order for them to be guaranteed to take place and for the ring-fence to operate effectively
- Given the scale and complexity of preparing operations for a ring-fence, operational subsidiarisation may be the logical method of implementation, but it raises separate financial and legal questions that the ICB must address

Executive summary
Introduction
Retail banking ring-fence – the right tool for the job?
The operational challenges of implementing a ring-fence
Grasping the opportunity – reforming substandard data
Possible solution – better data, more often
Conclusions
About Intellect
Glossary of key terms
< Previous page
> Next page

Grasping the opportunity – reforming substandard risk data

- Lessons from the financial crisis have not, as yet, been heeded. Data from banks was of an insufficient quality for regulators to spot and mitigate the financial crisis, and there has been no change in this almost three years later. A lack of a 'single source of the truth' represents a significant threat to the health of the financial system, and cannot be solved by a ring-fence
- The UK is lagging behind the US in its attitude towards the collation and interpretation of risk data. The Office of Financial Research in the US has been established to improve the level of data available to regulatory authorities
- Now is a 'once-in-a-generation' opportunity to address this underlying deficiency in the financial system, alongside other wide reaching reforms

Better data, more often

- The solution for a safer financial system lies in the implementation of two key changes to the way that data is collated by banks and viewed by regulators:
  - o Improved standards of data for regulatory and financial reporting
  - o More regular reporting of risk positions
- It is unlikely that banks will implement these large scale reforms under their own volition, and as such it is necessary for the Government/regulators to mandate this change
- There is a critical role for the ICB to play as part of its current review, in advocating that banks reform their data collation and reporting systems, and that regulators evaluate their own capabilities. An oversight in an issue as fundamental as this has the potential to significantly reduce the effectiveness of the ICB's own recommendations

Executive summary
Introduction
Retail banking ring-fence – the right tool for the job?
The operational challenges of implementing a ring-fence
Grasping the opportunity – reforming substandard data
Possible solution – better data, more often
Conclusions
About Intellect
Glossary of key terms
< Previous page
> Next page

Introduction

The ring-fencing of retail banks is a key reform proposed by the Independent Commission on Banking (ICB) and is aimed at tackling the perceived weaknesses of the financial system that were exposed by the recent banking crisis.

It is expected that a ring-fence would facilitate the continuation of crucial economic and social functions that the retail arms of universal banks perform, in the event of a failure of the investment banking arm. From providing access to funds for individuals; facilitating personal and commercial transactions; and providing finance to business; banks play a crucial role in the UK's economy. This was, after all, why the Government felt compelled to step in and bail out RBS, HBOS and Northern Rock and it is widely accepted that the consequences for the UK economy had they not done so, would have been significantly worse than what has been seen to date. As this paper will set out, there are numerous complex and potentially costly operational challenges in implementing a ring-fence, and a significant number of issues that the ICB needs to consider and prescribe alongside any recommendation to the Government.

However, the reality of the situation is that a retail banking ring-fence may go some way to easing public concern about the safety of their funds, but it is not a silver bullet for the reform of the financial system and there is a very large gaping hole in the reforms that are being undertaken – substandard risk analysis and data collation within individual banks. The ICB has yet to give a definition of a ring-fence and until it is able to do so it is more difficult to determine if this is a suitable tool to deliver a more stable financial system.

The fundamental problem lies at the heart of why regulators were unable to step in and avert the recent financial crisis in a timely manner. Neither they, nor the individual banks knew what risks they held because the data that banks collected was not granular enough to paint an accurate picture of the financial risk of each individual bank, and consequently the wider financial system. Since the beginning of the financial crisis, untangling the web of failed banks' holdings to determine who owes what to whom has created a significant additional burden on regulators as they seek to make sense of the scale and depth of the impact of the crisis.

If the objective of the Commission's review is to increase financial stability through reform of those banks whose collapse could potentially pose the greatest threat to the economy, a retail banking ring-fence will not achieve this on its own. Ultimately, if the regulatory authorities are unable to identify and mitigate the build up of risk on an institutional and systemic level, the ring-fence becomes less a safeguard and more a front line defence against the effects of financial instability, not the role it was designed to achieve.

> '...if the regulatory authorities are unable to identify and mitigate the build up of risk on an institutional and systemic level, the ring-fence becomes less a safeguard and more a front line defence against the effects of financial instability'

This inability to monitor systemic risk is, ultimately, one of the major contributory factors to the massive public spending cuts that UK citizens are all now facing. By failing to spot the buildup of risk across the financial system and within a number of specific banks, the tripartite authorities were unable to step in and mitigate this threat in a timely manner. Instead, they had to pump £1.3 trillion into the banking system which, as is common knowledge, has had a significant negative effect upon the state of the UK's finances and our wider economy.

The financial system is at a crucial juncture and there is currently a once in a generation opportunity to actually reform it for the better, from the bottom up. This paper will set out some of the key issues that the ICB should consider as part of its ongoing review.

Executive summary
Introduction
Retail banking ring-fence – the right tool for the job?
The operational challenges of implementing a ring-fence
Grasping the opportunity – reforming substandard data
Possible solution – better data, more often
Conclusions
About Intellect
Glossary of key terms
< Previous page
> Next page

Retail banking ring-fence – the right tool for the job?

- **A retail banking ring-fence is a measure of last resort against financial instability. If it comes into play, it means part of a bank has already failed, with negative economic consequences. It should be the last line of defence within the financial system, not on the front line. If the ICB recommends a ring-fence, it should complement other regulatory reform initiatives that are currently being implemented rather than trying to undertake the same tasks**
- **Intellect's members believe that the same result, i.e. a retail banking division which will continue to provide critical economic services, may be provided for under current reform initiatives and the implementation of better risk analytics and data within banks**
- **The ICB should examine the disaster recovery strategies already in place within banks which essentially seek to achieve the same thing. A ring-fence could form part of a bank's existing disaster recovery strategy**
- **However, the ICB has yet to provide a definition of a ring-fence. It is significantly harder to determine what the possibilities, challenges and issues around a ring-fence are, when the concept has not been sufficiently defined**

It is likely that the implementation of a ring-fence for the retail banking services within the UK's universal banks will be a significant business change challenge for all banks. Each bank is built upon a multitude of complex layers of people, processes and technology (PPT), and the challenges of constructing a ring-fence that will allow a retail bank division to continue to function, when the investment banking arm has failed, is significant. Each bank will approach this challenge in a different way depending upon whether they implement a narrow or wide ring-fence, i.e. based on what products and services they decide to protect within the ring-fence. For some, implementing a retail bank ring-fence will not be as significant a task as it may be for others.

However the desired end result is that the services within a universal bank will be separated to a degree that, in the event of a failure of the non-ring-fenced bank operations, there will still be the functionality in place to allow customers to extract our cash from an ATM, pay for our groceries with our debit/credit cards or finance the expansion of our business almost seamlessly.

Such preparation cannot take place overnight and, as such, if a ring-fence is ultimately required to be implemented, it will place significant demands upon a bank's resources and may cause disruption to existing services. However, this task is eminently possible using technology that already exists. The challenge emanates from the poor state of the bank's IT systems and this cannot be used as an excuse. For regulatory and business improvement reasons, there is a strong case for banks to upgrade their entire technology platforms, not only to allow them to comply with current reform initiatives, but also to modernise their appeal and capabilities which have been limited in recent years by their aging IT systems.

> '...if a ring-fence is ultimately required to be implemented, it will place significant demands upon a bank's resources and may cause disruption to existing services. However, this task is eminently possible using technology that already exists'

< Previous page
> Next page

'If the ring-fence is to be successful, it needs to ensure that the economically critical services that banks provide can continue following the failure of the non-ring-fenced parts of the bank. For this to happen it needs to be able to rely on systems that can continue to operate'

It will be important that the ICB, if it recommends this policy option to Government, appreciates the full scale of the implementation challenges that banks face, and level of intricacy that the ICB's proposals will have to cover in order for the ring-fence to work effectively. This section will outline some of the key challenges and considerations for the ICB and banks in implementing a ring-fence and, therefore, some of the issues that the ICB must take into account over the remainder of its review.

What will a ring-fence achieve?

If this is the policy direction that the ICB ultimately recommends, can it actually have the desired effect of increasing the stability of the financial system?

As per the ICB's high level objectives of increasing financial stability, it is anticipated that by creating a ring-fence for the retail functions of all universal banks, the retail bank will continue to provide its crucial economic services and the public will feel significantly more reassured about the safety of their funds. The run on Northern Rock in September 2007 started after it publically admitted that its liquidity was at dangerous levels for it to continue to operate, by seeking liquidity support from the Bank of England. Northern Rock became the first UK high street bank in 150 years to face a bank run, and the images of depositors lined up outside the bank to withdraw their funds as quickly as possible is symbolic of the wider banking crisis.

The ring-fence is essentially a tool that is meant to curtail such activity by reassuring the bank's customers that their funds are safe and ensuring there is enough liquidity within the retail bank for it to continue operating. However, other than allowing depositors access to their funds, it is anticipated that the ring-fence will allow the retail bank to continue to provide other economically critical services, such as:

- **Payments systems**
  Perhaps the most critical systems to the UK economy that are currently 'residing' within universal banks are payments systems. If the investment banking arm fails, it would put the payments system – which all areas of universal banks rely upon – under threat. The failure or disruption of a payment system provided by a bank or a central payments hub as a result of the failure of a bank, will negatively affect individuals and businesses, could de-stabilise financial markets and cause wider economic disruption. In short, disruption to the UK's network of payments systems would be a significant systemic risk. If CHAPS ceases to function, even for a short duration, billions of pounds would be stuck in limbo – and this would have significant negative consequences for the UK economy.

  Payment systems are a critical example of the economic services that banks currently serve and also an example of the fundamental threat to the UK economy should they not be able to serve this function. One of the drivers behind the ICB's review is to stop a future economic crisis and ensuring the safety of a bank's payments systems is critically important to achieving this.

- **Provision of economic catalysts - loans, finance, etc**
  It is also important for the wider economy that a ring-fenced retail bank is able to continue to offer finance for individuals and businesses should the non-ring-fenced banking division fail. This is especially important with regards to SMEs in the current economic climate and when taken against the backdrop of banks currently failing to hit the lending targets set as part of Project Merlin.

  However, ensuring the continuation of banking services to SMEs, which currently sit within both retail and investment banking arms of banks, could pose a significant challenge for banks in terms of the changes that would be required to their systems. Currently it is the case in most UK banks that SME IT systems straddle the intersection between the retail systems environment and investment banking. Services for SMEs include providing retail banking services (accounting, payments, branch services etc...) and most large banks provide services for SMEs with turnover less than £5 million per year through their retail systems and retail channels. However, banks also provide corporate banking services, which in most banks reside within the investment banking arm. Additionally, SME's account for a large proportion of the payroll for the UK (and indeed other countries), and if SMEs' liquidity is hampered in any way, a failure to make payroll and other payments to and from SMEs would add further pressure to the stress on the financial system. It is economically critical that banking services for SMEs continue should the investment banking arm fail.

Executive summary
Introduction
Retail banking ring-fence – the right tool for the job?
The operational challenges of implementing a ring-fence
Grasping the opportunity – reforming substandard data
Possible solution – better data, more often
Conclusions
About Intellect
Glossary of key terms
< Previous page
> Next page

Ultimately, if the ring-fence is to be successful, it needs to ensure that the economically critical services that banks provide can continue following the failure of the non-ring-fenced parts of the bank. For this to happen it needs to be able to rely on systems that can continue to operate and it needs to be separately capitalised.

What will a ring-fence not achieve?

The ring-fence is essentially a tool of last resort to ensure that the failure of the non-ring-fenced activity division of a bank does not negatively impact upon its economically critical functions. It does not help to ensure that this failure does not take place in the first place. It is a politically popular argument to state that if a bank has acted irresponsibly or has made bad decisions in the past, it should be allowed to fail. However, there will be economic fallout from the failure of the non-ring-fenced division, in the shape of job losses; and the reduction in availability of finance for businesses in the UK. The failure of, for instance, the investment banking arm will also have a significant impact upon the reputation of the UK as a global financial services centre. The inward investment into the UK on the back of this reputation is substantial, and if there is a failure within this system, this will have a limiting effect on this.

So, the ring-fence is a last line of defence, and should not be on the front line. There are a number of reforms being undertaken to make the financial system safer, but it does appear that there has been a potentially dangerous oversight in this regard. Specifically this is giving the Financial Policy Committee (FPC) the tools to do its job, i.e. identify and mitigate the build up of systemic risk. As this paper will set out, this issue has not been addressed since the banking crisis and the ability of regulators to identify and act against risks within the financial system, despite the shifting of functions and responsibilities, is just as limited as it was before the crisis.

Living wills and better data

However, it is arguable that if the ring-fence was meant to be more than an exercise in reassuring a public which has, understandably, had its faith in the safety of the banking system shaken by events since 2007, it is an expensive and perhaps unnecessary way of achieving this. This could instead be achieved through the adaption of a 'Living Will' to incorporate measures to ensure the continuation of banks critical economic services; and the submission of more granular, accurate and timely risk data by banks to regulators.

As set out below, Living Wills are central to the global financial reform agenda and are a key plank of G20 reform policy. Living Wills involve the creation of plans for each bank to prolong their ability to function (Recovery) and also plans to ensure the bank can fail in an orderly manner (Resolution), and their development is well under way by both banks and regulators. It would therefore seem logical that the ICB considers how a ring-fence could dove tail into this existing reform measure or even how an adapted Living Will which incorporates critical economic services (such as access to funds, payments etc...) could fulfil the same objective as a ring-fence.

This adapted Living Will could be backed up by the implementation of better risk management systems on an institutional level. The provision of 'better data' (covered in more detail below) will afford regulators the ability to monitor the build up of risk within individual banks, allowing it to step in when it was deemed necessary to do so. As the Bank of International Settlements has recently stated, there is significant need for banks to increase the standard of their risk data and for regulators to develop frameworks within which this can be captured and analysed.

Intellect believes that the ICB should, as part of its ongoing review, undertake a comparative analysis of the proposed ring-fence and a combination of existing reforms that are already being undertaken. From a cost/benefit position, it is important that all options that may achieve the same result are considered.

Ring-fence = disaster recovery

Disaster recovery is the processes, policies and procedures related to preparing for recovery or continuation of technology infrastructure critical to an organisation after a natural or human-induced disaster.

As this paper will set out, people, processes and technology are critical to the operation of individual banks and it is essential that in the event of a significant disruption or disaster, these systems can continue to

function or can be recovered rapidly. To all intents and purposes, implementing a ring-fence for a retail bank to ensure that it can continue to operate in the event of a failure of the non-ring-fenced operations, will be the same principle as ensuring that a bank has a disaster recovery strategy in place to deal with other potential disruptions, such as a natural disaster.

In the United States, all banks have had disaster recovery plans in place since the federal government mandated them in 1983. These disaster recovery strategies in many firms were tested by the tragic terrorist attack on the World Trade Centre, where many banks had significant operations, on September 11th 2001. However, the banks that were affected by the attack were able to continue to operate because these disaster recovery strategies were effective.

In 2005, the UK tripartite regulatory authorities conducted a survey of the ability of 60 of the most significant financial services and infrastructure providers to recover from major operational disruption such as a natural disaster or terrorist attack. The results indicated that those firms and financial infrastructure providers who represent the core of the financial system had highly resilient IT systems and could recover critical functions rapidly following major operational disruption.[1] Ultimately, banks already take the issue of disaster recovery very seriously and the strategies that are already in place for these banks would help the ICB define what a ring-fence should look like and how it should be implemented.

It is the technology behind the bank's operations and the banks' data that needs to be recovered in the event of a natural disaster, terrorist attack or other disruptive event. Banks already spend significant amounts of money in ensuring that there are adequate strategies in place to ensure that they can continue to operate in such circumstances. It is the same technology that needs to continue to operate within a ring-fence in the event of the failure of the non-ring-fenced operations of a bank and preparation of implementation strategies for a ring-fence should be considered in this context.

If the ICB ultimately advocates retail banking ring-fences, it should identify how these can be built within existing disaster recovery plans that are already in place for the UK's universal banks, in order to avoid duplication of resource/effort and to ensure that a ring-fence does not negatively impact upon these existing strategies. A ring-fence does not need to be a separate entity and could be implemented as part of a bank's wider disaster recovery strategy.

'...banks' IT systems are too complex and intertwined to be separated into a retail ring-fence overnight. Or anything close to overnight. There needs to be preparation of a number of systems so that a retail ring-fence is in effect already in operation before there is any failure of the investment banking arm'

1 FSA, 'Tripartite authorities asses the resilience of the UK financial sector', 14 December 2005

Executive summary
Introduction
Retail banking ring-fence – the right tool for the job?
The operational challenges of implementing a ring-fence
Grasping the opportunity – reforming substandard data
Possible solution – better data, more often
Conclusions
About Intellect
Glossary of key terms
< Previous page
> Next page

The operational challenges of implementing a ring-fence

- **The ring-fence will be complex, time consuming and potentially expensive to implement as a result of the complex and intertwined IT systems within banks. The bank will also have to consider people and processes alongside the technology. The scale of the task will depend upon the bank, its unique operations and what products/services each chooses to place in the ring-fence**
- **A retail banking ring-fence is a measure of last resort against financial instability. It has to ensure that crucial economic services provided by the bank continue in the event of a failure of the non-ring-fenced division. The people, processes and technology that underpin these crucial economic services must therefore be separated and prepared in advance of any such failure, so that they may function in a stand-alone retail bank.**
- **The ICB will need to prescribe minimum scenario-based outcomes to ensure that crucial economic services continue and which the industry can work towards implementing**
- **However, the ICB will need to mandate the systems changes necessary for banks to implement a ring-fence, in order for them to be guaranteed to take place and for the ring-fence to operate effectively**
- **Given the scale and complexity of preparing operations for a ring-fence, operational subsidiarisation may be the logical method of implementation, but it raises separate financial and legal questions that the ICB must address**

Whilst complete structural separation of banks has been considered as an option by the ICB in order to ensure that the economically critical retail functions of banks are able to survive a failure of the investment banking arm, the sheer level of upheaval and change that would have been required to implement this would have been significant.

Retail ring-fencing is, for many, seen as a compromise that will facilitate this safety net but at the same time not impact as heavily upon banks. However, Intellect believes that in reality this may not be as clear cut as this and that implementing a retail ring-fence will not be hugely different to implementing structural separation - in terms of scale of change to banks' internal systems and operations.

A key section that points towards the potential scale of this change can be found within the ICB's Interim Report:

"Key to improving the resolvability of universal banks is ensuring that their different business functions can be separated in a crisis over a matter of days. Some functions need to be open the following working day, meaning initial resolution needs to be effected over a weekend."[2]

As is outlined below, banks' IT systems are too complex and intertwined to be separated into a retail ring-fence overnight. Or anything close to overnight. There needs to be preparation of a number of systems so that a retail ring-fence is in effect already in operation before there is any failure of the investment banking arm, so that in the event of such a failure, the retail bank can continue to provide retail banking services to customers. If the systems that are critical to a bank being able to undertake its critical economic and social functions (these are outlined below) are to remain live within a ring-fenced retail banking structure, they must be separated, to all intents and purposes, as if they were being prepared for full structural separation.

As a general rule of thumb, the more services are moved within the ring-fence, the greater the complexity of the change programme and the greater the cost and duration and the greater the operational risk. However, as outlined above, it should not be deemed an option for banks to use complexity as a mitigating factor to avoid the systems change that is long overdue, for both business and regulatory reasons.

2 P80, Independent Commission on Banking, Interim Report

Executive summary
Introduction
Retail banking ring-fence – the right tool for the job?
The operational challenges of implementing a ring-fence
Grasping the opportunity – reforming substandard data
Possible solution – better data, more often
Conclusions
About Intellect
Glossary of key terms
< Previous page
> Next page

> ‘One of the crucial roles for the ICB, and something that must be part of any recommendation to implement a ring-fence, is the prescription of detailed scenario based outcomes of the services that the ring-fenced retail banks should be able to perform in the event of a failure of the non-ring-fenced operations’

To put this in context, Intellect members had previously estimated that, because of the complexity and intertwined nature of the IT systems of larger, systemically important banks, full structural separation could take anything between 3 and 5 years, dependent upon the particular bank. Whilst separating out essential people, processes and technology that currently serve both investment and retail banks will not be as time consuming as full separation, it will still be a significant undertaking to ensure that they are separated sufficiently to continue to function almost seamlessly in the event of a failure of the non-ring-fenced operations.

However, a more focused analysis of what the operational implications of a retail banking ring-fence are would be possible if the ICB was able to define precisely what it means by a ring-fence and what it envisages it will look like. Intellect recommends that a major facet of the ICB’s remaining work should be focused on developing a definition so that it can be determined if a ring-fence is an appropriate measure, and what demands implementation will place on banks.

People, processes and technology (PPT)

Whilst technology underpins the functions of all financial services providers and initiating a ring-fenced retail bank within a universal bank will, to all intents and purposes, require the separation of multiple systems from front to back office, it may be misleading to limit the operational challenges to just IT. People and processes go hand in hand with technology, and without one element of this equation banks would not function. It will therefore be important for the ICB to ensure that the ring-fence takes into account all these aspects together. A failure to ring-fence roles and appreciate the full end to end nature of processes will prevent the ring-fence from fulfilling its function and, ultimately, negate the point of it.

However, it is also the case that for the provision of outsourced solutions to the ring-fence, through shared services for example, people and technology are inseparable anyway. This paper puts forward the operational implications of a ring-fence, in the context of people, processes and technology.

Outcome based separation of services – economically critical vs non-critical

There are a number of services that banks supply that perform economically and socially critical roles and it is of paramount importance that that these are ‘always on’, even in the event of the investment banking arm of a universal bank failing. The PPT within a bank that is critical to the provision of these services will therefore need to be separated from the investment arm (where they are not already separated) and should be fully functioning before any failure takes place. Consequently, these services should be treated as a priority in preparing a ring-fenced retail bank. To all intents and purposes it was these services, and the PPT that support them, that the Government was saving when it bailed out RBS and HBOS during the financial crisis.

As all banks have different business and operating models with their own unique systems that underpin their activity, they will all have to implement a ring-fence from different starting positions. Therefore, one of the crucial roles for the ICB, and something that must be part of any recommendation to implement a ring-fence, is the prescription of detailed scenario based outcomes of the services that the ring-fenced retail banks should be able to perform in the event of a failure of the non-ring-fenced operations. These scenarios need to cover each individual critical economic service that a retail bank should continue to perform and highlight the detailed aspects of their requirements. They should describe a level of granularity that is quantifiable and can be consistently implemented across all banks that the ring-fence proposal would apply to.

Example

- ‘In the event of a failure of the non-ring-fenced operations of a bank, a customer of the same bank should be able to continue to withdraw cash from an ATM’.

In isolation, this statement would not be prescriptive enough to ensure that all economically critical requirements are assured and should be accompanied by a more detailed scenario which sets out additional imperatives for banks. In drafting a detailed scenario, the ICB might want to consider the following questions:

Executive summary
Introduction
Retail banking ring-fence – the right tool for the job?
The operational challenges of implementing a ring-fence
Grasping the opportunity – reforming substandard data
Possible solution – better data, more often
Conclusions
About Intellect
Glossary of key terms
< Previous page
> Next page


- If the retail bank customer was reliant upon cleared wages from a corporate or government, would that still be available?

This starts to define the scope of 'retail banking' and the extent to which consumers can have trust in the implementation of the ICB's proposals

- If a retail bank or corporate customer had an existing overdraft, would they be able to continue to draw funds against this?

It will be essential for banks to have an accurate, granular and up to date risk reporting model in place for this to happen and it is essential, notably for SMEs in the current economic environment, to be able to continually rely upon their day to day banking facilities

- Will customers be able to continue to withdraw cash from any UK ATM?

This may lead to banks having to consider how they maintain a linkage to ATMs operated by third parties

- Will customers be able to continue to withdraw cash from overseas ATMs?

If the ICB insisted this was a prerequisite, banks would therefore have to ensure that their ring-fenced operations were still linked in with international payments infrastructure.

There will be many scenario based outcomes that the ICB will need to prescribe as part of any recommendation to ring-fence retail banking operations, and these could relate to the following economically critical services:

- Payments services
- Provision of finance and funding to SMEs
- Continued provision of security for customers' funds and details

These examples are not exhaustive and Intellect is not attempting to lead the ICB into what prerequisites it should prescribe to banks. However, what is clear is that ultimately the public needs to have faith in the continuation of services from their retail bank, or there will once again be the threat of a run on a bank. By prescribing these scenarios, this will go a significant way to achieving this and will allow banks to consider how they have to adapt their own unique systems to achieve the desired end result.

One area that requires urgent attention, not just in the context of implementing a ring-fence, but more broadly in terms of ensuring that wider reforms, including those eventually proposed by the ICB, are effective, is the issue of risk analytics and reporting. As section 3 of this paper will outline in more detail, this is a significant gap in the current programme of reforms and there is a strong case for the ICB to consider this as part of its ongoing review.

However, there are also a number of back office services which, although not economically critical, will be required for the ring-fenced retail bank to function beyond the initial hours and days following the failure of the investment banking arm. These may include (non-exhaustive):

- Accountancy systems
- Business intelligence
- Admin - payroll, HR, etc
- Channels to market
- Intranet delivery for group services – for services to individuals and businesses

If these services and the PPT behind them are not in place in the short-medium term, the retail bank will simply not be able to function and this will have the same end results – a run on the bank or in a worst case scenario, bank failure, which will negatively impact upon the economy. It will therefore also be important for the ICB to prescribe outcome-based scenarios for these processes so that these services are also prepared. The ICB may also want to prescribe when these services are prepared for a ring-fence. A bank will be able to function without these services for a short period of time, and so a bank may not see it as beneficial (in the context of the ongoing implementation of other regulatory and business requirements) to implement these for a scenario it may feel will never happen. In which case, it is important that the ICB seeks assurances and can stress test the plans of each individual bank.

< Previous page
> Next page

An additional consideration for the ICB is that banks may not intend to invest resource now in preparing non-critical systems, if there may be a strategy for the bank's holding company to sell off the retail banking functions in the event of a failure of the investment banking functions. If this is the case there would, logically, be no reason for banks to invest resources now in preparing non-critical systems for a ring-fenced retail bank.

Intellect notes recent reports that one of the major banks has plans to prepare a payments platform for the ring-fenced retail bank that can operate for 3 months in the event of a failure of the investment banking arm. This begs the questions – 'what is it planning to do with the retail bank after these three months' and 'why does this payments platform only exist for three months?'

Implications for the separation of data

Data is critically important to the efficient running of different business lines within a bank and, on an holistic basis, allows the bank to function on an organisational level. It is also critical for the bank's own risk management systems and for allowing regulators to undertake their roles effectively. The data that banks hold, be it credit reference data, the Single Customer View or, on the investment banking side, business and market data, is their biggest asset. However, that there is limited granularity and transparency of this data is a significant failing on the part of the banks. This data is used to underpin their business operations (e.g. credit reference data, which facilitates loans to individuals and businesses) and it is currently of insufficient quality for banks to fulfil this function adequately. By way of example, an inability to differentiate between an SME that is credit worthy and one which is not (typically because of a lack of sufficiently granular data on both), results in a loan being refused or being priced at unrealistically expensive rates. This has contributed to the need for Project Merlin and, latterly, to targets not being hit as demand amongst SMEs for overly expensive loans remains low.

This data is also not of sufficient quality for regulators to adequately supervise the activities of banks - as demonstrated by the financial crisis. As things stand the collation and sharing of data between disparate business areas within individual banks is not as effective as it could be and, as outlined in section 2 of this paper, the standard of data that is shared with regulators is not sufficient for them to undertake a truly effective supervisory role.

The ICB will have to consider what effects the creation of a ring-fence will have on data sharing within these banks and in particular what effect this may have upon the ability of banks to provide economically critical services to SMEs and individuals. The ICB will also have to investigate how an operationally separable ring-fence would affect banks' ability to adhere to Single Customer View requirements. If there is disruption to the ability of banks to differentiate between customers in order to compensate customers of a failing bank or determine credit worthiness, this may ultimately have a negative economic impact.

Time and cost to implement a ring-fence

Time

Most major transformational projects within banks are at least two–five years in duration, based upon the complexity of the individual bank's legacy systems and the complexity of the bank itself.

An accurate assessment of the time it will take for a bank to complete its preparations for a ring-fence is not possible until minimum requirements for this ring-fence are defined. However, to put this in context, examples of change programmes that affect a bank's core systems can typically take a number of years to complete. Indeed, Lloyds integration of HBOS's systems has led to significant consolidation of IT systems across the two organisations (focusing on IT infrastructure including data centres and networks; an integrated IT platform for retail banking; and a single dealing and trading platform for wholesale banking). The project began in early 2009 and has been undergoing testing this year. The project is already over two and a half years old. Santander's own project to integrate Abbey's systems onto its own core banking platform has taken 4 years to complete and it took RBS over two and a half years to migrate NatWest's customer base (i.e. the systems and data relating to NatWest's banking customers), following its acquisition by RBS in November 2000.

What is clear however, is that the ICB, as part of its deliberations, should allow banks sufficient time to assess, plan and deliver the required changes in the context of other regulatory and business requirements.

Executive summary
Introduction
Retail banking ring-fence – the right tool for the job?
The operational challenges of implementing a ring-fence
Grasping the opportunity – reforming substandard data
Possible solution – better data, more often
Conclusions
About Intellect
Glossary of key terms
< Previous page
> Next page

Cost

Cost is almost impossible to calculate on a per bank basis at this juncture, given the number of variables and the fact that each bank is different. However, it is possible to put the likely level of cost into perspective. Based on precedent, the cost of core banking implementation projects in the past have each been more than £100 million.

The ICB should consider that, as there is currently significant pressure on systems changes from other regulatory reforms, some of these changes may tie in with the changes that will be necessary to establish a ring-fence. As outlined in Section 3, there will be increasing pressure from regulators over the coming months and years for banks to invest in their risk management systems, so that regulators actually have the required standard of information to perform their duties. By improving the standard of this data, banks will also be able to improve their own business performance as decisions will be based on more in depth analysis of their holdings and positions.

This is an example of another challenge for the ICB, the need to align regulatory change with the demand/need for change for business efficiency purposes. This could help the ICB deliver change that is wider reaching, could be implemented quicker and within the same cost/benefit parameters.

Operational Risk

The complexity of the separation for each bank will lead to increased operational risk, which in turn could have a significant systemic impact. Each bank will be required to untangle complex business processes which underpin technology data, applications, infrastructure and networks. The risk emanating from the technology associated with business separations must not be underestimated and will require extensive focus in order to mitigate it. It is critical that the ICB appreciates that in advocating a ring-fence to protect the economy from the systemic risk of bank failure, it may also be exposing the economy to systemic risk from the operational failure of some elements of the services provided by banks, through unintended IT system failure.

Successful resolution of Systemically Important Financial Institutions (SIFIs) – Living Wills

The ICB should also consider that if a ring-fenced retail bank is to operate smoothly, the failing division of the bank needs to be allowed to do so in an orderly manner i.e. in a way that does not impact upon the continued operations of the retail bank.

Currently there is very little practical, detailed guidance on the likely form of recovery and resolution plans, what their contents should be, and how they will in fact ensure adequate resolution or recovery procedures. Given the heavy reliance on IT systems and infrastructure that most banks have, it is vital that the technology aspects of the Living Will are adequately considered.

Under HM Treasury's (HMT) 2010 consultation on Living Wills[3], each SIFI is required to create a business information plan (BIP). While HMT's paper emphasises that the BIP must be proportionate, the paper generally does not explore the technology aspects of how the bank is operated in any detail. If an effective BIP is to be developed and used by an administrator who will have to enter the bank cold on day one of an administration, the following will have to be examined more closely:

While a BIP maps the contracts it may not map back effectively to individual systems. In a stressful situation were a bank is insolvent, full identification of which systems are in use to run which operations will be key. This may be relatively straightforward for specific applications or programs, but the further down the technology stack one moves, the more difficult it is to identify which systems are used to operate specific applications. This complexity has increased considerably with the advent of virtualisation, and client based solutions where the infrastructure is either shared between the number of different systems, or (perhaps the most complicated scenario) where management of data may move rapidly from within the investment bank's own systems, to be processed by a third party and then interact with other internal systems of the bank. The technology aspects of this will be key to understand which parts of a failed firm can be divested and which retained. Without a detailed description of this technical infrastructure and an understanding of how everything fits together in practise, the objectives of the BIP will fail.

3 HM Treasury, 'Establishing resolution arrangements for investment banks'

Executive summary
Introduction
Retail banking ring-fence – the right tool for the job?
The operational challenges of implementing a ring-fence
Grasping the opportunity – reforming substandard data
Possible solution – better data, more often
Conclusions
About Intellect
Glossary of key terms
< Previous page
> Next page

'...it will be necessary for the ICB to further investigate... what it sees as acceptable parameters for an operational subsidiary and what the possible legal issues are.'

Therefore in order for banks to adequately prepare a ring-fence for their retail bank functions, their needs to be clearer guidance (and therefore consideration by banks) on the technology aspects of the BIP.

Intellect would argue that as this issue has not yet been broached by HMT, it should either become a consideration for the ICB, or HMT should be pressed for its assessment on this issue. If there is little direction on how Living Wills will work in practice, the effectiveness of a retail bank ring-fence could be undermined.

Operational Subsidiarisation

Given the scale of the operational issues that banks face in preparing a ring-fence, operational subsidiarisation potentially offers the quickest and least disruptive path to implementation and it could be argued that the technical implications of ring-fencing outlined in this paper then become much less onerous and challenging.

It has already been stated that operational subsidiarisation is the preferred choice of many of the banks – i.e. setting up a separate entity that would own the IT systems for both the investment banking and ring-fenced retail sections of the bank.

However, there remain challenges within this implementation option that will require further investigation by the ICB. For instance, how can regulators ensure that the level of separation is still sufficient for the retail bank to continue to provide banking services, in the event of a failure of the investment banking arm?

Similarly, if this subsidiary was outsourced, it would also need to have the financial resources to be able to continue to function if the investment arm failed. There would be separate challenges around assessing this and continually monitoring the financial capabilities of the outsourced subsidiary. On a financial level there would also be a number of legal issues that the ICB will have to consider – specifically around guarantees that investors in the failed investment bank would not have recourse to the funds assigned to the operational subsidiary so that it can continue to provide the necessary systems for the ring-fenced retail bank.

This would be a logical manner to implement a ring-fence. However, it will still require the separation of what are multiple shared systems so that the ring-fenced retail bank can continue to operate, almost seamlessly, should the investment arm fail.

Each bank's model for operational subsidiarisation will be different as each will have different views about which systems should be separated out and which should not. As outlined above, it may be that decisions are made on what IT systems need to go into the subsidiary based on the complexity and cost of separating them out from existing systems. However, if an operational subsidiary is a realistic proposition for banks, the decision on how to establish this should be based upon what will best allow a ring-fence to function, rather than convenience for individual banks. Therefore it may be necessary for the ICB to either:

- Evaluate each proposal on a case by case basis to ensure the subsidiary would be able to fulfil its function if/when it was required to do so; or
- Prescribe minimum standards for an operational subsidiary

Operational subsidiarisation has already been undertaken to a degree by some banks, placing functions such as their human resources IT systems into a separate corporate structure, which can then provide these services to all business areas within the bank. This suits banks with an international structure – as standardised IT systems can then be supplied to different parts of the bank, in different countries. This, therefore, may be a viable option for many of the UK's banks that have an international business offering. Setting up a ring-fenced retail bank may have a significant impact upon how its UK based operations relate to their activity in other countries. By setting up an operational subsidiary that can house key IT systems, this may be more easily reconcilable with operations in other countries where a ring-fence is not required.

Regardless of approach, it will be necessary for the ICB to further investigate this issue, exploring what it sees as acceptable parameters for an operational subsidiary and what the possible legal issues are for this option.

3 HM Treasury, 'Establishing resolution arrangements for investment banks'

< Previous page
> Next page

Grasping the opportunity – reforming substandard risk data

- **Lessons from the financial crisis have not, as yet, been heeded. Data from banks was of an insufficient quality for regulators to spot and mitigate the financial crisis, and there has been no change in this almost three years later. A lack of a 'single source of the truth' represents a significant threat to the health of the financial system**
- **The UK is lagging behind the US in its attitude towards the collation and interpretation of risk data. The Office of Financial Research in the US has been established to improve the level of data available to regulatory authorities**
- **Now is a 'once-in-a-generation' opportunity to address this underlying deficiency in the financial system, alongside other wide reaching reforms**

Figure 1 – Independent Commission on Banking Terms of Reference

The objectives of the ICB, as set out in its terms of reference, are:

- "Reducing systemic risk in the banking sector, exploring the risk posed by banks of different size, scale and function;
- Mitigating moral hazard in the banking system;
- Reducing both the likelihood and impact of firm failure; and
- Promoting competition in both retail and investment banking with a view to ensuring that the needs of banks' customers and clients are efficiently served, and in particular considering the extent to which large banks gain competitive advantage from being perceived as too big to fail."

If the ICB is to fulfil its objectives (set out above), it needs to look beyond a retail banking ring-fence, and evaluate the opportunities for mitigating the risk within the financial system before it becomes necessary for a ring-fenced retail bank to operate in the wake of the failure of the investment banking arm. This opportunity is all about data.

As HM Treasury sets out on page 3 of its recent consultation on 'A new approach to financial regulation'[4], 'The crisis was caused by the failure... of regulators to spot the risks that were building up across the system as a whole'.

This was a sentiment also shared by the Public Accounts Select Committee as it stated in a recent report[5] that "Both banks [RBS & HBOS] found it difficult to provide the Treasury with appropriate and robust data on their assets. We found this alarming. It places a question mark over the standards and practices of the banks themselves, and whether or not there was effective oversight by regulators and the banks' own auditors'.

More recently, the Bank of International Settlements made the following statement in June 2011 as part of its 81st Annual Report:

'The recent financial crisis highlighted shortcomings in policymakers' ability to measure systemic risk. Gaps are evident in both the analytical framework and the available firm-level and aggregate data that policymakers and market participants use in making decisions. These gaps hinder market participants in pricing and managing risk and policymakers in monitoring and responding to vulnerabilities. This experience should prompt improvements in macro surveillance and data collection.'[6]

4 P3, 'A new approach to financial regulation: judgment, focus and stability, p3
5 Public Accounts Committee 31st Report, HM Treasury: Asset Protection Scheme
6 P83, BIS Annual Report 2010/11, Bank for International Settlements

< Previous page
> Next page

Nearly four years on from the onset of the financial crisis and it appears that the lessons that should have been learnt, have not been and that regulatory reform of the financial system appears to be skirting around the major issue of 'better data', without tackling it head on. Whilst there are a number of banks now looking at addressing the inadequacies of their risk data, there is no evidence that this is part of a fundamental policy of data improvement by banks that will not only allow them to act more responsibly through better risk data, but would also allow them to play an economic catalyst role that they have a responsibility to assume. There are lessons to be learnt, not just from the crisis itself where inadequate risk information meant an inadequate regulatory response, but also from the aftermath of the financial crisis as substandard credit and customer reference data held by banks meant that finance dried up and an economy in shock, sank into depression.

It is also concerning that, despite the widely accepted supervisory failings during the financial crisis, there are no plans for UK regulators to install a system that would let them better collate information from banks so that the build up of systemic risk can be identified and mitigated. That this precise task has now been allocated to the recently established Financial Policy Committee would suggest that this might be a deficiency that would be addressed as a priority. Although to date, it has not. Similarly, as a subset of this problem, there has only recently begun to be a greater focus within banks on increasing the quality of their risk management frameworks – specifically their risk analytics and the standard of risk data that is collated and shared with regulators. Yet there is no guarantee of this standard, nor prescription of what regulators require from this data, in order for them to undertake their role.

Intellect would argue that the ICB should look beyond the politically motivated proposals for a ring-fence, which can only do so much to protect the UK economy and which will be complex, expensive and time consuming to implement, at the area most in need of reform. In a time of wider financial reform, there is no better time to do so.

Learning from Lehman – why have we not heeded the warnings of the financial crisis?

On an institutional level, the downfall of Northern Rock in 2007 was the first major event in recent years to highlight the need for financial services providers to have responsive, up-to date systems so that information can be shared, evaluated and acted upon. In 2008, the demise of Bradford and Bingley was, in part, because of antiquated information systems; the bank's senior figures did not have access to the company's up-to-date financial figures.

> 'Nearly four years on from the onset of the financial crisis and it appears that the lessons that should have been learnt, have not been and that regulatory reform of the financial system appears to be skirting around the major issue of 'better data', without tackling it head on.'

On a systemic level, the financial crisis also exposed the weakness of the UK's financial services regulatory framework, in particular the asymmetry of information between the regulators and financial services providers and revealed the dangers of systemic risk. In effect, there was a failure on two levels:

- The banks themselves were either not able or not willing to prioritise the reporting of enterprise risk to board level. That banks were taking excessive risks during the economic boom has, in hindsight, exposed this failure of corporate governance

Executive summary
Introduction
Retail banking ring-fence – the right tool for the job?
The operational challenges of implementing a ring-fence
Grasping the opportunity – reforming substandard data
Possible solution – better data, more often
Conclusions
About Intellect
Glossary of key terms
< Previous page
> Next page

'This lack of 'a single source of truth' from each of these individual banks presents a significant challenge for the FPC – i.e. how can it determine where the risk is across the financial system and act to mitigate it, if accurate information about risk held by individual financial institutions cannot be determined?'

- Regulators received significant amounts of data in from banks but were unable to interpret it, were unable to make informed judgements and therefore unable to make decisive interventions in the market. That there was no standardised format to this data meant that in trying to build up an holistic picture of the financial system, regulators were not only trying to compare apples and pears, but oranges, bananas, and so forth.

The result was that the prudential regulatory system was not equipped to manage systemic risk. The information gap between the tripartite regulatory authorities and the financial institutions slowed the response to the financial crisis. Whilst the Government was able to step in and save RBS and HBOS, albeit at a high cost, this was undertaken without full knowledge of the risks that the banks faced, and an accurate assessment of what systemic risk their collapse would have posed to the financial system as a whole. In the U.S. where the regulatory system suffered from the same deficiencies, a slowed response time meant that the authorities could, to all intents and purposes, only act to save one of Lehman Brothers and AIG. The decision was made to let Lehman Brothers fail, demonstrating the inability within the regulatory system to react quickly and effectively. That it was expected that Lehman would fail in the months leading up to the autumn of 2008 makes the inadequacies of the data available to regulators even more shocking.

What is alarming is that the reform of the financial system since the crisis has not taken on board this crucial point. Whilst political focus has been on those whose actions and deficiencies were deemed to have caused the financial crisis (see 'bankers' bonuses' and 'dismantling the tripartite regulatory authorities'), little attention has been paid to learning from the crisis and installing the systems and processes that are required to avoiding another crisis. As things stand, there is still no system in place to monitor the build up of risk across the financial system, despite the financial crisis demonstrating that such a resource was badly missed.

There is a critical point here for the work that the ICB has been undertaking and the effectiveness of a possible ring-fence for retail banking – a ring-fence will not protect our economy from failing banks in the long run, it will help the continuation of everyday banking facilities but the longer term effects of another banking failure will be, as outlined above, significant in the longer term. The effectiveness of the whole ring-fenced retail bank proposition will be undermined if it does not also focus upon the broader issue of systemic risk, and the substandard reporting and financial data that they have been and will continue to receive from individual banks.

Substandard data, the next financial crisis waiting to happen

The problem stems from the fact that the data that regulatory authorities currently have access to from financial services providers is neither in a uniform standard (making it much harder to collect, compare and analyse what it means), nor is it granular enough.

Therefore this data is not of a sufficient standard to allow regulators to paint an accurate picture of the realities of the positions of individual banks, and in doing so, of the financial system.

This lack of 'a single source of truth' from each of these individual banks presents a significant challenge for the FPC – i.e. how can it determine where the risk is across the financial system and act to mitigate it, if accurate information about risk held by individual financial institutions cannot be determined?

Compounding this issue is the regularity of data submission to regulators by individual banks. Whilst each bank will be different, in most cases the standard can be measured in weeks rather than days and this represents a significant problem for two main reasons:

- Much can happen over the space of a few weeks and the health of a particular bank can deteriorate significantly over this time. Any risk or liquidity issues that arise in between scheduled reports will have time to get significantly worse, and require a significantly bigger response from the regulators, than if reporting was on a more frequent basis. In effect, the seeds of another financial crisis could be sown before the regulators are aware of what has happened – if indeed it is then able to interpret the data that it receives from the bank.
- In the event of another financial crisis, regulators will almost certainly require data from banks on a daily basis. Many banks have reporting frameworks that are

'That the OFR has recently started defining reporting standards for the financial community puts it way ahead of the FPC in terms of establishing tools to head off the next financial crisis'

an integration of data, analysis and people intervention across multiple business units. These processes rely upon manual intervention and are often difficult to change at short notice. It will take significant changes to current reporting systems within banks for this to take place. Without frequent and accurate data from the banks, the ability of the regulators to make decisive and effective interventions in the financial system is severely hindered and it may be too late for action to be taken to save a particular bank. We saw this first hand in the responses of the UK and US authorities during the financial crisis, and very little has changed since. In a worst case scenario, a regulator acting on poor data in a financial crisis could actually exacerbate the situation. The Senior Supervisors Group, which includes representatives from regulators across multiple countries, including the UK, stated in a document published at the end of 2010, that 'some firms still require days and weeks to completely aggregate risk exposures; few firms can aggregate data within a single business day"[7].

The Governor of the Bank of England has stated that there is no need for banks to provide more data to the regulators so that they can perform their regulatory duties. This may well be true – **what is needed is 'better data' and more often** – that can be collected, analysed and turned into information that the regulators can act upon if required. Much of the data that is supplied by banks to regulators will mean very little to them in its current format and in effect there is a great deal of 'wastage' – i.e. data that is collected but cannot be usefully interpreted of used in any constructive way. It may well hold valuable information therein, but not enough and/or it cannot be analysed sufficiently by regulators under current circumstances.

An additional consideration is that if the standard of data being collected by banks is not improved, how does a bank, or indeed a regulator, determine if it is in a situation where the investment banking arm needs to be resolved? The entire ring-fenced retail bank issue is reliant upon a premise that it will become clear enough when the ring-fence will 'kick in' through the bank's existing risk management provisions. This is not the case.

UK - lagging behind in the use of 'better data'

In the United States the Office of Financial Research (OFR) has been established within the US Treasury Department, as a result of the Dodd-Frank Bill. Its remit is to improve the quality of reference data available to policymakers and facilitate more robust and sophisticated analysis of the financial system. In effect, the OFR is permitted by law to demand data from financial companies including banks, hedge funds, private-equity firms and brokerages. It would be able to track information such as counterparties for credit-default swaps and would, crucially, afford regulators the sort of system-wide overview (including darker parts of the market) that will allow it to identify when and where there is a risk to financial stability. The OFR also has the authority to set out new legislation based upon its findings. All this, and the fact that the OFR has recently started defining reporting standards for the financial community, puts it way ahead of the FPC in terms of establishing tools to head off the next financial crisis.

On a more general level, US regulators are significantly ahead of their UK counterparts in terms of their attitude towards setting standards for data. The Commodity Futures Trading Commission (CTFC) has recently set up a sub-committee to help develop accepted standards for describing, communicating and storing data on complex financial products. Members range from traditional operators in the financial system such as Barclays Capital, Thomson Reuters and Citi, through to data experts such as Google. This is indicative of the importance that regulators are attaching to the better management of data as a means to protect the US financial system from risk.

On a European level the European Systemic Risk Board (ESRB) was established, again by law, in December 2010 under the auspices of the European Central Bank and has a similar function to the OFR. Whilst it is not yet as advanced as the OFR in terms of its use of data, it is also still way ahead of the UK as it has acknowledged that data standards that will allow it to collate information from 75 different member organisations (including the ECB, the EU national central banks and EU national regulatory authorities amongst others) are not sufficient to allow it to undertake its role effectively.

That both these institutions and the Bank of International Settlements have acknowledged that current data standards are insufficient to afford regulators the necessary tools to identify the build up of systemic risk should be heeded by the IBC and the Bank of England

7 P10, "Observations on Developments in Risk Appetite Frameworks & IT Infrastructure", Senior Supervisors Group

< Previous page
> Next page

and acted upon now, whilst the regulatory system is being reformed.

Herein lies a crucial competition issue for the future of the UK as a centre for financial services. If the expertise and tools of the regulatory authorities are deemed to be below that of other markets, there may ultimately be a detrimental effect on the UK's current position as the leading global financial centre. The gap between the City and its competitors has been shrinking in recent years, and there is a danger that if the regulators are deemed to not be able to manage systemic risk appropriately, the UK may not find itself at the pinnacle of this particular league table for too much longer.

Continued opacity of the financial system

On a high level, the complexity of the global financial services industry and the products within it have themselves provided something of an opacity which is directly responsible for complicating the task of viewing the whole of the financial services system, and assessing risk therein. There is currently very little motivation for financial services institutions to reduce this opacity as a lack of transparency is conducive to the development of complex and, by that measure, profitable products. In short, it is good for business.

Other sectors, such as pharma, aerospace and the chemicals industry have all increased their own transparency through regulator-enforced modernisation. Within both the pharma and chemicals industries, companies are legally responsible for the quality of the data that they send to the regulator. If it falls below the required standard, legal sanctions become an option. There is no such requirement within the financial services sector and as such the quality is below the required level, and there is little motivation for banks to rectify this situation.

It is no surprise that as transparency of a specific industry is increased, the effectiveness of that specific regulator increases as well. If industries such as this can modernise, there is a strong argument for an industry as economically and socially critical as the financial services industry, to modernise as well. The financial services industry is also capable of the same modernisation of its data flows (precisely what is required for a systemic risk utility), despite its protestations. This capability is already demonstrated on a daily basis through the vast amounts of trade data that is channelled at great speed between institutions operating in the capital markets (high frequency trading is a notable example).

Whilst the financial system remains opaque, it will continue to be extremely difficult to monitor the build up of risk across it, and consequently avert another banking crisis. A reduction of this opacity however, will only be possible if the regulatory authorities receive clearer data from the banks themselves and are able to develop an understanding of the technology that underpins the entire system.

> 'If the expertise and tools of the regulatory authorities are deemed to be below that of other markets, there may ultimately be a detrimental effect on the UK's current position as the leading global financial centre'

Golden opportunity to fix the system, not patch it up...

As the financial system undergoes one of the most significant period of regulatory scrutiny since the 1930s, there is currently a once-in-a-generation opportunity to tackle some of the fundamental, underlying problems within the financial system. It could be argued that whilst the reform options that are being examined are wide-reaching they do not, in many cases, bury down into the crutch of the problem. This is the 'plumbing' of the system. i.e. how data is collated and how it flows to those bodies (such as regulators) that need access to it. If the opportunity is not taken now, at this critical juncture, to address the clearly visible deficiency of substandard reporting data and the risk that this poses to the health of the financial system, it could take another crisis before it is addressed.

< Previous page
> Next page

> 'There is... now an imperative for banks to demonstrate a heightened sense of responsibility so that public trust in their procedures and intentions can be restored.'

According to the Bank for International Settlements:

"Unfortunately, memories tend to be short, and significant risks to the banking sector generally emerge after a period of complacency bred by apparent calm. Thus, the work to strengthen banking systems must be carried through now, when the crisis is still fresh in people's minds and policymakers and the wider public understand the urgency of an effective response.'[8]

As set out in this paper, implementing root and branch reforms to reporting systems in each bank, along a standardised format, is a significant task and as such it is something that has, to date, been avoided. Banks will not advocate such change because of the cost and disruption it would bring to their businesses, and regulators are largely unaware of the deficiencies in the data that they are receiving. Consequently, there is nobody driving change to this systemic deficiency.

However, we are currently in the position where we should be tackling these difficult issues – where they should be addressed head on for the good of the stability of the future financial system. There is no questioning the fact that fundamental reform of the financial system is required, hence the importance being attached to the ICB's review and its final recommendations. It is important that as other fundamental reforms are planned and implemented, the issue of poor data quality is also addressed. To not address this underlying failure of the financial system that played such a significant role in the financial crisis, yet advocate the establishment of a retail banking ring-fence would be 'missing the point' and would run the risk of reducing the effectiveness of other reforms. Such as a retail bank ring-fence.

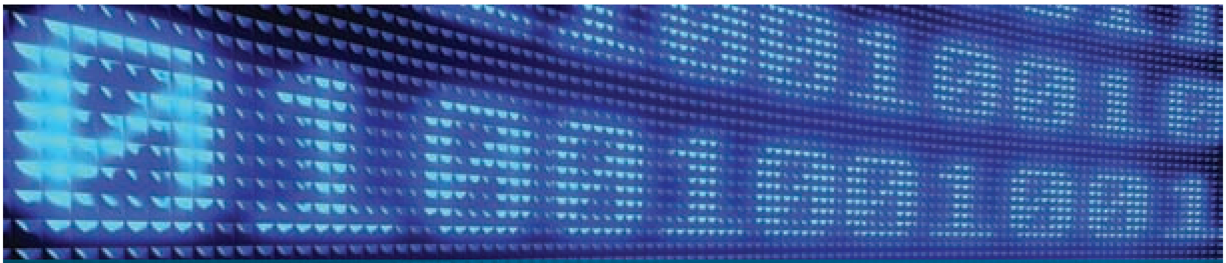
Similarly, there is also now an imperative for banks to demonstrate a heightened sense of responsibility so that public trust in their procedures and intentions can be restored. As Paul Tucker, the Deputy Governor of the Bank of England, has recently stated, there needs to be a new Social Contract to restore the balance between the public which has underwritten the banking system, and the banks that supply economic services such as loans[9]. Banks now need to take their responsibilities to the economy and the public more seriously and the need to change the Social Contract, which in its previous guise failed, epitomises the need for banks to also change the way they operate to fit this new relationship with the public. The first step to achieving this is transparency.

Better data creates transparency, which may not be ideal for the business models of many banks (see above), but it is important that the banks recognise that there needs to be change in the way they collate and share data on their operations, if there is to be a more stable financial system. It will undoubtedly be a burden on the banks to improve the granularity of their data and standardise it, but it is their responsibility to undertake this reform. Especially when this is cast against the backdrop of the cuts to frontline public services that has been the result of public money being used to bail out banks.

Again as BIS has stated, intensive and intrusive regulatory supervision will now be necessary to ensure that a resumption in increased levels of risk taking by banks can be monitored and countered where necessary. If there are measures that can be taken to avoid this happening again in the future, banks should recognise their responsibilities to do so and the ICB has a role to play as part of its review in ensuring this happens.

9 Speech given by Paul Tucker, Deputy Governor Financial Stability, member of the Monetary Policy Committee and member of the interim Financial Policy Committee. At the British Bankers' Association Annual International Banking Conference, London 29 June 2011

Executive summary
Introduction
Retail banking ring-fence – the right tool for the job?
The operational challenges of implementing a ring-fence
Grasping the opportunity – reforming substandard data
Possible solution – better data, more often
Conclusions
About Intellect
Glossary of key terms
< Previous page
> Next page



Possible Solution – Better data, more often

- **The solution for a safer financial system lies in the implementation of two key changes to the way that data is collated by banks and viewed by regulators:**

  o Improved standards of data for regulatory and financial reporting

  o More regular reporting of risk positions

- **It is unlikely that banks will implement these large scale reforms under their own volition, and as such it is necessary for the Government/regulators to mandate this change**

- **However, there is also a critical role for the ICB to play in advocating that banks reform their data collation and reporting systems, and that regulators evaluate their own capabilities. An oversight in an issue as fundamental as this has the potential to significantly reduce the effectiveness of the ICB's own recommendations**

Improved standards and accessibility of reference data

Essentially there are two interdependent facets to providing a solution to a lack of oversight of systemic risk, both of which will require the backing of regulators and policy makers to make them happen, as it is unlikely that the banking industry will implement them voluntarily. These are:

- Improved standards of data for regulatory and financial reporting

- Regular reporting of risk positions, with the requirement to provide frequent updates during periods of financial volatility

The 'single source of truth' is an important objective to reach. A large proportion of data submitted to regulators does not offer any information to them. As the Governor of the Bank of England has set out, regulators do not need any more information. That may be true, but what they do need is the large amounts of meaningless data that they do receive to be improved, in order to provide them with insightful and actionable information about the health of individual banks, and therefore the wider financial system. In terms of defining what 'better data' looks like, Intellect believes that there should be a review of the key metrics that will best help regulators perform their duty of identifying and mitigating risk on an institutional and systemic level. As outlined below, there is a role for both the ICB and the regultory authorities in identiifying what these key metrics are.

In its deliberations over the remainder of its review, the ICB should also look to the initiatives that are already being undertaken on a global level, specifically the ongoing G20 data gaps exercise which is working towards developing an institutional-level data template for globally systemically important financial institutions and a framework for data access and usage.[10]

Building a mandate – a role for the regulators

As Francis Gross, Head of External Statistics at the European Central Bank has recently stated, regulators must be driving change in international standards for reference data if it is going to happen, as relying on the banks to do so would be like "asking cats to herd themselves"[11]. There is also the argument that as the opacity of the financial system is good for business, shedding light on it may be deemed to be counter to the banks' own commercial interests. On top of this, there may be reluctance amongst the banks to give up their data to regulators, as it is deemed a source of competitive advantage. However, it is the case that standardised reference data can reduce the underlying data gathering and reporting costs (incurred through the

10 'The Financial Crisis and Information Gaps: Report to the G20 Finance Ministers and Central Bank Governors', International Monetary Fund & Financial Stability Board, Oct 29 2009
11 "Elusive Information", Financial Times, February 15, 2011

Executive summary
Introduction
Retail banking ring-fence – the right tool for the job?
The operational challenges of implementing a ring-fence
Grasping the opportunity – reforming substandard data
Possible solution – better data, more often
Conclusions
About Intellect
Glossary of key terms
< Previous page
> Next page

> 'A retail ring-fence is not a silver bullet that will ensure the stability of the UK's economy on its own. It may well reduce the worst effects of the collapse of a bank, but it should be complemented by key reforms in other areas.'

collation of data from disparate corners of a bank's operations, and from multiple legacy systems that may also use different data formats) and will help banks adopt a greater degree of cross-departmental risk analytics. The greater the ability of a bank to share risk information across departments and lines of business, the better for business planning and, ultimately, for its own bottom line.

However, the benefits will be accrued in the medium term and it will require a substantial investment of funds in the short-medium term in order to implement better data standards. Banks are unlikely to see the short term commercial benefit at a time when compliance costs from the wide ranging reform agenda must also be factored into the equation. Consequently, if banks are going to undertake the internal change programmes that are beneficial to their own commercial objectives, but also to the stability of the financial system, there needs to be a mandate from Government or the regulator to invest in building this set of standards and processes.

Before this happens there needs to be a concerted period of introspection and evaluation on the part of the FPC where it can identify what monitoring capabilities it wants to have in three or four years time. Once it has identified the capabilities that will allow it to perform its stated objective of effectively monitoring and mitigating risk, it can prescribe the 'reverse engineering' of the relevant system. This may take the form of a systemic risk 'early warning system' from the dashboard down to the standardisation and improvement of reference data within individual banks.

Building a mandate - a role for the Independent Commission on Banking

Intellect appreciates that addressing the issue of systemic risk is not a direct concern of the ICB, although it has within its remit the requirement to take this issue into account. However, there is a significant risk of the Commission's final recommendations and the reforms that the Government implements being undermined by a financial system that still contains significant unidentified threat, and a regulator that does not have the tools to perform its role of protecting the system.

Consequently there are two actions that the ICB might consider as part of its final report:

- As part of its final recommendations, the ICB should also recommend that banks are compelled to make significant efforts to increase the granularity of the data they are collating, so that a more accurate view of the risks that each individual bank holds can be ascertained, and therefore the FPC can be equipped with the appropriate tools to undertake its own role of identifying and mitigating the build up of risk across the financial system. Ultimately, there needs to be standards established and mandated – not just about data format, but about quality. As stated above, this is not about more data, just better data, and knowing what to do with it.
- The ICB should play a role in encouraging other elements of the financial system, specifically the FPC, to examine their own areas of responsibility and what they could do to improve their own regulatory performances; complementing the reforms that the ICB is examining. Paul Tucker, Deputy Governor of the Bank of England has already said that the Bank of England can do a lot better job of regulating the financial system. Examining the Bank's ability to perform its role is a necessary first step to achieving this.

A retail ring-fence is not a silver bullet that will ensure the stability of the UK's economy on its own. It may well reduce the worst effects of the collapse of a bank, but it should be complemented by key reforms in other areas. Ultimately a retail banking ring-fence should be the last line of defence within the financial system, not on the front line. If the ICB recommends a ring-fence, it should complement other regulatory reform initiatives that are currently being implemented rather than trying to undertake the same tasks.

Executive summary
Introduction
Retail banking ring-fence – the right tool for the job?
The operational challenges of implementing a ring-fence
Grasping the opportunity – reforming substandard data
Possible solution – better data, more often
Conclusions
About Intellect
Glossary of key terms
< Previous page
> Next page

Conclusions

Over the remaining two months of its review, it is important that the ICB forms an overarching view of what a retail bank ring-fence can achieve in the context of wider reforms of the financial system that are currently being undertaken. There is significant work already being undertaken to improve the stability of the financial system and already significant implementation burdens on banks.

However, this is not an argument for the ICB to shy away from proposing wide reaching reforms. On the contrary, the ICB is playing a hugely important role in shaping the future of the UK's financial system and the financial crisis has demonstrated that things do need to change if we are to reduce, as far as possible, the negative effects of another financial crisis. Therefore its final recommendations should be the result of careful consideration of the realities of the financial system and of the individual banks within it. A ring-fence will be a complex and costly project to implement on a bank by bank basis, and if there are ways to achieve the same result with less duplication of effort (such as Living Wills and existing disaster recovery strategies within banks) the ICB should evaluate how this might fit in with its objectives. However, there is also another crucial issue here. The ICB's Interim Report asked for views on a ring-fence, but then did not sufficiently define what it saw as a ring-fence. If the possible solution is not defined, it is hard to determine if it's the right solution. Intellect would recommend that the ICB looks to define a potential ring-fence in more detail over the remainder of its review period, whilst continuing to consult all relevant stakeholders on how this tighter definition changes the specific challenges that it poses.

What is clear, however, is that if the ICB does ultimately recommend a ring-fence, it will have to accompany this recommendation with a significant level of detail about what it believes should be included within the ring-fence. Intellect believes that this should be in the form of outcome based scenarios that will guarantee that a ring-fenced retail bank can continue to perform its crucial economic and social functions, should the non-ring-fenced operations fail.

A key issue that has so far been largely overlooked as part of the reform of the financial system is the inability of banks to deliver data of a suitable quality to regulators so that the build up of systemic risk can be monitored and mitigated. It was an inability to interpret the sheer quantity of data from banks that meant that the financial crisis was not identified in good time and actions taken to prevent it. There has been little change in the quality of this data since the banking crisis and consequently there remains a gaping hole in the reform of the financial system which has not yet been filled. A ring-fenced retail bank is not a silver bullet that will protect the financial system from a future crisis; it is a last line of defence. Currently the data that banks will submit to regulators and which, it is envisaged, will be used to make a decision whether to allow an investment bank to fail and its ring-fenced retail arm to continue to function, is not sufficient for this task. Therefore, if this outstanding reporting issue is not dealt with it will significantly impact upon the effectiveness of the reforms that the ICB is advocating. It is critical therefore that Government, regulators and, as part of its review, the ICB, address it as a matter of urgency.

> 'It is important that the ICB, as well as other policy makers and regulators, do not let the financial crisis go to waste and that they grasp this opportunity to fully address the underlying problems that are still present in the financial system and the individual banks themselves'

To paraphrase an old adage, it is important that the ICB, as well as other policy makers and regulators, do not let the financial crisis go to waste and that they grasp this opportunity to fully address the underlying problems that are still present in the financial system and the individual banks themselves.

Executive summary
Introduction
Retail banking ring-fence – the right tool for the job?
The operational challenges of implementing a ring-fence
Grasping the opportunity – reforming substandard data
Possible solution – better data, more often
Conclusions
About Intellect
Glossary of key terms
< Previous page
> Next page

About Intellect

Intellect is the UK trade association for the IT, telecoms and electronics industries; industries that generate around 10% of UK GDP and 15% of UK trade. Our Members include blue-chip multinationals as well as early stage technology companies and play a crucial role in virtually every aspect of our lives. Intellect articulates a cohesive voice for these industries across all market sectors, and is a vital source of knowledge and expertise on all aspects of the technology industry.

Alongside the technology industry's considerable footprint in the UK, Intellect also enables many other industries to operate efficiently in today's economy including:

- financial services
- creative industries
- retail
- transport and logistics
- manufacturing
- defence and aerospace
- pharmaceuticals

We are a trusted partner for Government, both in terms of policy development and policy implementation across numerous sectors. We look to ensure that all relevant engagement of policymakers and regulators with industry is both easy and as valuable as possible in order that the technology industry may play the fundamental role it merits in the success of UK plc.

Intellect's Financial Services Programme brings together over 150 suppliers of information systems, services and consultancy to the banking and insurance sectors.

Many of Intellect's Members are heavily involved in providing the fundamentally important technology platforms upon which the UK's financial services industry is built. For example, these Members help facilitate the 5.7 billion automated payments that are made through the banking system on an annual basis. Similarly, the 40 million online bank accounts that are registered in the UK would not function without the technological capability that our Members design and supply.

The relationship between the financial services industry and the technology sector is one of fundamental importance. As the Office for Fair Trading has recently stated, "IT systems are the backbone of retail banking activities and are essential to the safety and resilience of financial systems". Technology not only plays a critical role in the functioning of the full spectrum of financial services, it is a hugely important factor in ensuring that the individual institutions within it can operate more responsibly and remain competitive in the global marketplace. The right technology can help depress costs, reduce risk and increase the confidence of lenders and investors, all of which are of paramount importance in the current economic environment. Applied inappropriately or to the wrong ends and it can contribute to systemic risk, lead to reduced inward investment and ultimately have a detrimental effect on the economy.

Consequently, if the UK's banking sector is to be reformed to meet the challenges posed in recent years and provide the backdrop to economic recovery, policy not only needs to reflect what technology can facilitate today, but what it will enable in the future. Reforms will only be effective and durable if they take into account how it will be implemented and how the application of technology can be complementary. For an industry like financial services that relies so heavily upon technology, it is essential that regulatory authorities are equipped with a full understanding of it.

Further information on the role of technology in the financial services ecosystem can be found in Intellect's Financial Services Programme Executive Overview.

Intellect contact:

Ben Wilson, Head of Financial Services Programmes
T: 020 7331 2161
E: ben.wilson@intellectuk.org

< Previous page
> Next page

Glossary of key terms

Bank for International Settlements (BIS)
The BIS is an international organisation based in Basel, Switzerland, which fosters international monetary and financial cooperation and serves as a bank for central banks.

CHAPS
This refers to the Clearing House Automated Payment System which enables electronic transfer of money between two bank accounts that will clear the payees account on the same working day provided instructions are received before 3.15 pm. It is currently used by 19 settlement banks (including the Bank of England) and over 400 sub-member institutions.

Commodity Futures Trading Commission (CFTC)
The CTFC is an independent agency created by the US Congress with the mandate to regulate commodity futures and option markets in the United States.

European Systemic Risk Board (ESRB)
The ESRB is an independent EU body responsible for the macro-prudential oversight of the financial system within the European Union.

Disaster Recovery
Disaster recovery is the process, policies and procedures related to preparing for recovery or continuation of technology infrastructure critical to an organization after a natural or human-induced disaster.

Living Wills
Living Wills are detailed plans that would enable banks to stipulate in advance how they would raise funds in a crisis and how their operations could be dismantled after a collapse.

Office of Financial Research
The Office of Financial Research (OFR) was established within the US Treasury Department by the Dodd-Frank Wall Street Reform and Consumer Protection Act to improve the quality of financial data available to policymakers and facilitate more robust and sophisticated analysis of the financial system.

Operational Risk
In financial services this refers to the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

Operational Subsidiarisation
Operational Subsidiarisation refers to the placing of the critical infrastructure needed for a bank to keep processing transactions in a separate subsidiary from the rest of the group.

Senior Supervisors Group (SSG)
The SSG comprises senior supervisory authorities of major financial services firms from Canada, France, Germany, Italy, Japan, the Netherlands, Spain, Switzerland, the United Kingdom, and the United States. It exists to discuss emerging supervisory and risk issues and to work collectively on selected risk management weaknesses exposed during the financial crisis and develop information to be used by standard setters both internationally and within individual countries.

Single Customer View (SCV)
A 'Single Customer View' is the linking of customer data to provide an accurate and holistic view of any one customer across different channels and lines of business. It allows a better understanding of each individual and their relationship with an organisation, enabling them to reduce costs, manage risk, and increase revenue and profitability in customer-centric organisations.

Substandard Risk Data
This refers to data on risk which is not of a sufficient standard to allow regulators to paint an accurate picture of the realities of the positions of individual banks, and in doing so, of the financial system.

Systemic Risk
This refers to the risk of collapse of an entire financial system or entire market, as opposed to risk associated with any one individual entity, group or component of a system.

Systemically Important Financial Institutions (SIFIs)
These refer to certain financial institutions which are seen as so central to the financial system that their failure could cause traumatic damage, both to financial markets and to the larger economy.

< Previous page
> Next page