HM TREASURY

Sound banking:

delivering reform

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delivering reform

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1 Introduction

Banking reform

1.1 Reform of the financial sector is a Government priority. A healthy financial sector provides jobs, generates tax revenues and drives economic growth. However, the recent crisis – the worst in a generation – exposed critical flaws in the UK financial system, and emphasised the need for comprehensive and far reaching reform.

1.2 Much of this reform, relating to the reshaping of the regulatory system and the identification of systemic risks, is already being brought forward in the Financial Services Bill. That Bill has completed its progress through the House of Commons and is currently being scrutinised in the House of Lords.

1.3 The draft Financial Services (Banking Reform) Bill (the draft Bill) focuses on reform of the banking system and promotion of stability and competition through structural and related non-structural measures. The Government set up the Independent Commission on Banking (ICB) to recommend ways in which this could be achieved. The ICB issued its final report in September 2011, recommending a dual approach: the ring-fencing of vital banking services and increasing banks' loss absorbency. Together, the proposals will make systemically important banks safer and more resolvable:

- making banks better able to absorb losses;
- making it easier and less costly to sort out banks that still get into trouble; and
- curbing incentives for excessive risk-taking.

1.4 The Government issued a white paper consultation in June 2012, setting out how it intends to implement the Independent Comission on Banking (ICB) recommendations. Following the closing of that consultation on 6 September, this document provides an overview of responses to the consultation as well as the draft Bill and explanatory notes, ahead of pre-legislative scrutiny by the Parliamentary Commission on Banking Standards, chaired by Andrew Tyrie, scheduled to report by 18 December.

1.5 While the draft Bill is primarily focused on banking reform, other broader changes which will help ensure the integrity and robustness of the UK's financial system will also be brought forward. These include reform of the Payments Council and changes to the governance structure of the Financial Services Compensation Scheme (FSCS), which will be included in the Bill when it is formally introduced to Parliament early next year.

Structure of this document

1.6 This document is structured into three main parts. The next chapter presents an overview of the key policy areas covered in the draft Bill. The second part of the document – Chapters 3 to 5 – provides the technical and legal detail in the form of draft Bill and explanatory notes. Finally, the annexes include the summary of responses to the consultation and the impact assessment.

2 Policy overview

Introduction

2.1 This chapter outlines each of the key policy areas in the draft Financial Services (Banking Reform) Bill (the draft Bill) and those areas which we expect to include in the Bill on introduction and addresses some of the issues raised in the June consultation.

Banking reform:

- Ring-fencing vital banking services;
- Depositor preference; and
- The framework for implementing Primary Loss Absorbency Capacity (PLAC) requirements.

Broader reforms:

- Financial Services and Markets Act 2000 (FSMA) fees amendment;
- Financial Services Compensation Scheme (FSCS) governance reform; and
- Payments Council reform.

2.2 The main elements of each policy area, while being introduced in this chapter, are detailed in the draft legislative provisions (apart from FSCS governance reform and Payments Council reform). Therefore, this chapter should be read in conjunction with Chapter 3, which contains the draft Bill, and Chapter 4, which contains the draft explanatory notes.

2.3 The Government also committed to implement a number of other measures recommended by the ICB on loss absorbency and competition. These are being progressed through alternative means, and include:

Loss absorbency:

- The inclusion of a **bail-in tool** as part of the European Commission's proposed Recovery and Resolution Directive (RRD), which the Government expects will be implemented for banks and investment firms in the UK and other Member States through the transposition of the Directive;
- An **additional equity 'ring-fence buffer'** of 3 per cent of risk weighted assests (RWAs) (beyond the Basel III minimum standards) for large ring-fenced banks, which can be applied domestically through powers in the Capital Requirements Directive (CRD) IV and Capital Requirements Regulation (CRR) (the Council agreement includes a systemic risk buffer which the Government believes would be an appropriate channel);
- A **resolution buffer**, to ensure that systemically important banks have sufficient loss-absorbing capacity (beyond any minima) to mitigate the impact of any remaining barriers to their resolvability. It is anticipated that the authorities will have the powers and mandate they need to do this via the CRD IV variable Pillar 2

requirements, and through the inclusion in the RRD of the provision that banks be required to hold sufficient 'minimum eligible liabilities' (capital plus liabilities that can be bailed in by resolution authorities) to ensure that they are resolvable.

Competition:

- The Lloyds divestment resulting in a strong challenger bank. In July 2012, Lloyds Banking Group and the Co-operative Group announced they had reached headline commercial agreement on the Verde transaction. By Summer 2013, Lloyds will have rebranded the branches that will transfer to Co-op as TSB. Once the deal is completed (bearing in mind the state aid deadline is end November 2013), Co-op will gain 632 new branches (which have the best geographical spread across the UK of any bank); £23billion of assets; and around five million new customers plus 15,000 new employees. This will both create the sixth biggest bank in the UK and also a genuine, mutually-owned challenger to the major banks;
- The need for a transparent market. These recommendations are for the Office of Fair Trading (OFT) and the Prudential Regulation Authority (PRA) to implement, but the Government will support them as they develop their proposals. The Financial Services Authority (FSA) are publishing reviews on the prudential and conduct barriers to entry and expansion in the banking sector in Autumn 2012;
- Establishing a current account redirection service by September 2013. This is on track, with the Government holding quarterly interim meetings to hold the industry to account.

Report of the High-level Expert Group on reforming the structure of the EU banking sector

2.4 On 2 October, the High-level Expert Group tasked by the European Commission with making proposals for structural reform of European banks, chaired by Erkki Liikanen, presented its recommendations. These included strong support for a bail-in tool and a requirement for the structural separation of banks' trading activities from retail deposit-taking. The Government welcomes the structural reform measures in the Liikanen Group's report as a key contribution to the European and international debate on banking reform. The Group's proposal for ring-fencing of trading activities from deposit-taking has many similarities with the recommendations of the ICB, and the Group has noted that the Government's plans for ring-fencing of UK banks are compatible with the Liikanen recommendations. Now that the Liikanen Group has reported, it is for the European Commission to bring forward legislative proposals for banking reform in the EU. The UK looks forward to seeing the Liikanen proposals on the ring-fencing of trading activities put into practice across Europe.

The aim of the draft Banking Reform Bill

2.5 The draft Bill is designed to provide the Government with the necessary powers to implement the recommendations of the ICB. It is primarily an enabling Bill. That is, it provides the Treasury with the requisite powers to implement the policy underlying the Bill through secondary legislation. With a few very important exceptions, the majority of the detail of the policy will be set out in secondary legislation and regulatory rules. For example, the draft Bill introduces the concepts of 'core activities' and 'excluded activities' but currently only provides for one instance of each type of activity (respectively accepting deposits and dealing in investments as principal). The Treasury is given powers to make secondary legislation creating additional core and excluded activities, and providing for exceptions to the core activity and excluded activity set out in the draft Bill. This approach allows the Government to respond flexibly to changes in the banking system.

2.6 The draft Bill also:

- gives the Treasury power to make regulations governing the way in which the PRA may use its powers under FSMA to impose debt requirements on specified classes of institutions;
- amends the Insolvency Act 1986 and related Scottish and Northern Ireland legislation to provide that deposits which are eligible for protection under the FSCS are to be preferential debts; and
- gives the Treasury power to require the PRA, the Financial Conduct Authority (FCA) and the Bank of England to impose fees on members of the financial services industry in order to cover relevant expenses incurred by the Treasury in connection with membership of specified international organisations, such as the Financial Stability Board (FSB).

2.7 The Bill also sets out the balance between legislation (primary or secondary) and rules to be made by the regulator. Broadly, the Bill provides for the Treasury to set (in secondary legislation) the scope of ring-fencing policy(or what the ICB called the "location" of the ring-fence); that is, which activities are to be undertaken within ring-fenced banks, and which are to be prohibited or excluded and to whom ring-fencing applies. These are fundamentally social and economic issues, and are therefore rightly a matter for Government, accountable directly to Parliament. The Treasury may confer powers upon the appropriate regulator to determine technical matters, according to the purposes set out in primary and secondary legislation. The Government will consult fully with the regulator before conferring any such powers. In addition the Bill requires the regulator to use its existing powers to make rules governing the legal, economic and operational independence of the ring-fenced bank (what the ICB called the "height" of the ring-fence). Such issues are best dealt with by the regulator, who is best able to monitor, enforce, and update rules as banking practices evolve.

Ring-fencing

Policy summary

2.8 This policy aims to insulate banking services critical to individuals and small and medium-sized enterprises (SMEs) from shocks elsewhere in the financial system, and to make it easier to ensure continuous provision of those services. It does so by protecting those services from contagion from the wider financial system, including risks arising in the rest of a banking group, and, in the event of a failure of any part of the group, making it easier to resolve in an orderly manner, without putting taxpayer funds at risk. The policy will be achieved by 'ring-fencing' – introducing structural separation between services essential for individuals and SMEs, and wholesale and investment banking services.

Objectives for the FCA and PRA

2.9 The draft Bill provides for a continuity objective for the FCA and the PRA that will give them a duty, when dealing with matters related to ring-fencing, to protect the uninterrupted provision of vital banking services (known as core services) in the United Kingdom. The draft Bill sets out how the regulators are required to advance this objective. The objective means that, for example, the PRA should take steps to ensure that ring-fenced banks[1] are insulated from shocks that could cause a disruption to the continuity of core services, but also that, in the event of failure, either of a ring-fenced bank, or another part of its group, those core services can be maintained.

[1] The Bill refers to "ring-fenced bodies". In the first instance the Government believes that all ring-fenced bodies will be banks. For simplicity this document refers to "ring-fenced banks" throughout.

2.10 It is important to note that this does not mean that there should be a 'zero failure' regime for ring-fenced banks. On the contrary, ring-fenced banks should be allowed to fail, but in an orderly way, with the use of special resolution tools by the authorities where necessary. Ring-fencing will make it easier for the authorities to let them fail, as it will ensure that the core services being provided can be separated and can continue to operate independently from the rest of the group. For example, the best resolution approach for a failing banking group containing a ring-fenced bank may be a private sector sale of part or all of the core services, thereby maintaining continuity for depositors, while allowing the rest of the bank to go through an orderly administration process. In this respect, the continuity objective is entirely consistent with the PRA's general objective as set out in the Financial Services Bill, which, more broadly, intends that the PRA seeks to minimise the adverse effect that the failure of PRA-authorised persons could be expected to have on the stability of the UK financial system.

2.11 The continuity objective will be relevant when the regulators act in relation to ring-fenced banks and members of the same group as a ring-fenced bank. The new continuity objective will sit alongside the PRA's general objective,[2] which applies more broadly to all of the PRA's functions. The PRA must ensure that, where the continuity objective is relevant, it always acts compatibly with that objective. The Government is of the view that in the very great majority of cases, the continuity objective will be entirely consistent with the general objective. However, the continuity objective provides for specific focus on ring-fenced banks, and on the continuation of a particular set of activities. In those instances (likely to be rare) when the two objectives are in conflict, the PRA will be required to act compatibly with the continuity objective.

2.12 The FCA will have a more limited role in the regulation of the ring-fence and ring-fenced banks than the PRA, but the draft Bill nevertheless requires the FCA to advance the continuity objective when it does act in relation to ring-fencing. The FCA will need to ensure ring-fenced bodies conduct business appropriately and ensure its rules governing the conduct of ring-fenced banks are consistent with the continuity objective. Furthermore, there may be instances in the future in which the FCA becomes the primary regulator of a firm that has a ring-fenced subsidiary. The legislation requires the two regulators to set out the way in which they propose to advance the continuity objective in the memorandum of understanding between them to ensure that they are entirely coordinated and do not duplicate functions.[3]

2.13 Responses to the white paper consultation did not focus on the objectives of the FCA and PRA.

Core activities

2.14 The Government intends to ring-fence certain activities, where even temporary interruption could have severe implications for livelihoods and the UK economy. The ICB referred to these activities as "mandated activities". These are referred to in the draft Bill as core activities.

2.15 The Government believes that accepting deposits from individuals and SMEs should be a core activity. This means that the only UK banks which will be able to undertake this activity will be ring-fenced banks, and banks which have been exempted from the definition of a ring-fenced bank.[4] The draft Bill exempts building societies entirely from the definition of a "ring-fenced bank", though changes will be made to the Building Societies Act 1986 to bring it into

[2] See new section 2BA(1), inserted by clause 2 of the draft Bill.

[3] Under section 3E of FSMA, as amended by the Financial Services Bill, the PRA and FCA are required to prepare and maintain a memorandum of understanding, describing the role of each regulator in relation to the exercise of functions conferred by or under this Act which relate to matters of common regulatory interest.

[4] The rules on ring-fencing will not apply to branches of EEA banks which accept deposits in the UK under passport rights given to them in EU single market directives. Branches of banks incorporated outside the EEA will also be outside the definition of a "ring-fenced body"; though any such branch having a significant deposit taking business would be required by regulators to become a UK subsidiary – and so potentially a ring-fenced bank.

line with the ring-fencing provisions of the draft Bill.[5] The draft Bill also gives the Treasury power to exempt certain deposit takers from the definition of a ring-fenced bank by order.

2.16 It is currently anticipated that the Government will use this power to exempt deposit-taking firms with deposits from individuals and SMEs below a certain amount. Many respondents agreed with the proposal for an exemption for banks with a smaller amount of such deposits. Some industry respondents suggested the proposed threshold (£25 billion in deposits from individuals and SMEs) ought to be lower. The Government will confirm the threshold in secondary legislation.

2.17 The Government's proposal to carve out building societies from the ring-fence, but to amend the Building Societies Act 1986 where necessary to bring it into line with the ring-fencing provisions of the draft Bill, was supported by most respondents. A number of respondents expressed a concern that due to their particular structure, ring-fencing could prevent building societies from carrying out a number of activities, such as estate agency and independent financial advice, through subsidiaries. The Government does not propose to introduce legislative restrictions on such activities.

2.18 The Treasury will also have the power to determine when accepting deposits is not a core activity and therefore does not need to be undertaken by ring-fenced banks or exempt banks (e.g. firms below the *de minimis* threshold). The Government anticipates using this power in two main areas:

a to provide for deposits from larger companies to be held outside of ring-fenced banks if those customers wish; and

b to set a level of net worth, beyond which individuals may choose whether or not to place deposits in ring-fenced banks or non-ring-fenced banks.

2.19 The quantitative thresholds for these exemptions will be set out in secondary legislation and subject to further consultation.

2.20 Respondents to the white paper broadly supported a threshold of £6.5 million annual turnover for corporate depositors to be able to opt out of placing deposits in ring-fenced banks or exempt banks, although a few suggested a higher threshold. Some respondents suggested that companies below this threshold should still be able to opt out, while others disagreed strongly with this suggestion.

2.21 A number of respondents agreed with the threshold for high net-worth individuals of £250,000 in free and investable assets which was proposed by the Government in its white paper. Some suggested that this should be lower (at around the level of FSCS "insured" deposits), while others suggested it ought to be much higher (as high as £5 million). There were some concerns as to the way in which "free and investable assets" might be defined.

2.22 Deposit taking is the only core activity specified in the draft Bill. However, the draft Bill includes a power whereby the Treasury can introduce other core activities in the future should the need arise. This will ensure the Government has the flexibility to respond to financial innovation. The Government has no current plans to create additional core activities.

Excluded activities

2.23 Currently, within universal banks, the activities of investment and wholesale banking can pose a risk to the continuous provision of essential services, either by imposing losses on the bank, or by making the bank's resolution more complicated. The draft Bill therefore prohibits

[5] See clause 6 of the draft Bill.

ring-fenced bodies from undertaking certain excluded activities and will grant the Treasury the power to designate an activity as an excluded activity. These are activities described by the ICB as "prohibited activities".

2.24 The Treasury has taken a broad power to exclude activities, and most will be detailed in secondary legislation. However, the draft Bill provides that dealing in investments as principal is an excluded activity. This would exclude most of the derivatives and trading activities currently undertaken by wholesale and investment banks.

2.25 There may be circumstances in which it may be necessary or desirable to permit a ring-fenced bank to undertake an excluded activity. So the draft Bill gives the Treasury power to make secondary legislation providing for exceptions to the excluded activity.

2.26 As acknowledged by the ICB, the process of accepting deposits and extending loans is inherently risky. In managing these risks, it may be prudent for ring-fenced banks to enter into derivatives contracts, or hold financial instruments to manage liquidity, interest rate or credit risk. It is not the Government's, nor was it the ICB's, intention to prevent banks from managing themselves prudently. The Government will set out in secondary legislation the circumstances in which dealing in investments as principal may be permitted. The Government will also set out the conditions that will be attached to any such permissions, by, for example, providing that all such derivatives contracts must be centrally cleared. This exemption will be equivalent to what the ICB called the "ancillary activities" exemption.

2.27 The ICB said that ring-fenced banks could be permitted to provide some risk management products to customers provided that they did not require the bank to hold capital against market risk, give rise to trading book treatment, or did not threaten resolvability. The June white paper recognised the benefits of allowing firms to provide such products directly to clients and committed to exploring whether it is possible to develop a framework which would allow them to do this, while meeting very clearly the conditions set by the ICB. The white paper set out a number of conditions that might need to be set in secondary legislation, for example, limiting the permissible products to interest rate and foreign exchange instruments, restricting market exposure to a small percentage of capital, and requiring such contracts to be centrally cleared or standardised.

2.28 Some consultation respondents were concerned that a total ban on investment products would mean ring-fenced banks would not be able to provide clients with important hedging and risk management services. Others noted that such products could be provided without increasing market risk, or hindering the resolvability of ring-fenced banks. Some respondents argued strongly that ring-fenced banks should be permitted to provide simple retail investment products that would involve embedded derivative products. Others, however, thought that ring-fenced banks should not be permitted to sell derivatives, and raised concerns about the risks of mis-selling of derivatives, or advocated full separation between retail and investment banking.

2.29 The Government welcomes the contributions received in response to the options set out in the white paper. Recent events involving the mis-selling of derivative products have demonstrated the need for robust conduct, as well as resolvability, safeguards. The Parliamentary Commission on Banking Standards will be considering the appropriate regulation of bank conduct and ethics, including safeguards against the mis-selling of financial products. The Chancellor has therefore written to the Chair of the Parliamentary Commission to ask his Commission specifically to consider the type of regulations required to guard against the risks, including the conduct risks, that allowing ring-fenced banks to sell derivatives could create. The Government will look forward to receiving the Commission's recommendations when they report on legislative matters by 18 December. Following receipt of the Commission's advice, the Government, as with other matters, will consider the implications for subsequent secondary legislation.

Prohibitions

2.30 The draft Bill also gives the Treasury power to impose prohibitions on ring-fenced banks in secondary legislation. Such a power will work in a similar way to the power for the Treasury to create new excluded activities, but it is intended to capture transactions with specified types of counterparties or transactions in particular jurisdictions. This power will enable the Treasury to implement the ICB's recommendations on, among others, restricting a ring-fenced bank's exposure to financial institutions and restricting its geographic scope.

2.31 The secondary legislation to be made under the draft Bill will impose restrictions on ring-fenced banks' exposure to financial institutions, and set out the classes of institution to which exposure will be restricted, what sorts of exposure will be relevant for these purposes, and the conditions under which an exposure may be permitted, for example for the purposes of managing liquidity or other risks associated with a ring-fenced bank's core business.

2.32 In response to the white paper, some respondents suggested that transactions with insurance companies should not be prohibited, arguing that they are unlikely to transmit financial shocks to the ring-fenced bank. Some smaller banks suggested that including them as prohibited counterparties would have significant adverse affects on their funding models as they would likely rely heavily on ring-fenced banks for funding. The Treasury is reviewing these concerns and will consider them carefully in preparing the secondary legislation required to implement the ring-fencing regime.

2.33 The white paper suggested that ring-fenced banks should not have non-EEA branches and subsidiaries, in order to insulate ring-fenced banks from shocks and enhance resolvability. It noted that, where arrangements are in place that ensure that undertaking activity in a non-EEA jurisdiction does not present risks to resolution (for example having mutual recognition of resolution regimes) such a prohibition may not be necessary. The Government proposes to provide in secondary legislation for such a judgement to be applied on a case-by-case basis.

2.34 A number of respondents to the white paper expressed concern that too stringent prohibitions could have an adverse impact on ring-fenced bank's ability to support trade finance outside the EEA, or inward investment. Others proposed that the Crown Dependencies should not be prohibited jurisdictions for ring-fenced banks. The Government will review these concerns in making secondary legislation.

Ring-fencing rules

2.35 The draft Bill requires the appropriate regulator (currently the PRA) to exercise its power to make rules governing ring-fencing. This requirement is designed to give effect to the ICB's recommendations for what it described as the "height" of the ring-fence. The draft Bill requires the regulator to make rules to ensure that the ring-fenced bank is able to act independently of the rest of its group while carrying on its business. In relation to ring-fenced banks that are members of a group, it specifies the areas in which rules should be made, including holding shares in other corporate entities, entering into contracts with other members of the group, governance of the ring-fenced bank, restricting payments that a ring-fenced bank may make to other members of the group and disclosure. These provisions do not limit regulators' power to make general rules.

2.36 These requirements are designed to ensure that a ring-fenced bank interacts with the rest of its group on a third party basis, and that it remains legally, economically and operationally independent. The requirement for dealings between a ring-fenced bank and the rest of its group to be conducted on a third-party basis was also endorsed by the Liikanen Group in its proposals for EU banking reform. The areas specified in the draft Bill reflect the areas in which the ICB made specific recommendations, for example, on intra-group large exposure limits, holding equity stakes in non-ring-fenced entities and having an independent board. However, the draft Bill allows for the details to be set out by the regulator in rules, following the policy and purpose first set out in primary and secondary legislation. The development of such rules are technical matters which reside most appropriately with the regulator.

2.37 Respondents to the white paper expressed some concerns regarding the levels proposed for intra-group large exposure limits and suggested they should be relaxed. The Government is of the view that having a high and strong ring-fence is integral to the success of the policy, and tough intra-group large exposure limits are part of this. The Government believes that the requirements in the draft Bill on the regulator to set rules that ensure the independence of the ring-fenced bank will necessitate tough intra-group large exposure limits, although the final calibration will be a technical matter for the regulator.

Pensions

2.38 The Treasury plans to require banks to take action to ensure that ring-fenced banks may not be liable for debts to pension schemes that might arise as a result of a failure in the rest of a ring-fenced bank's group. The Treasury is working with key stakeholders, including the pensions regulator and the Pension Protection Fund to ensure that this change is delivered in a way which is equitable, affordable and maintains existing protections for pensioners to the extent that is consistent with the primary policy objective of splitting pension schemes. The Government welcomes the contributions it has received on the steps thought necessary to achieve this. As policy development and stakeholder engagement is ongoing, pension provisions do not feature in the draft Bill at this stage. However, an enabling power will be included in the Bill on Introduction.

Tax

2.39 The Treasury has also explored ways in which a ring-fenced bank's joint and several liability for VAT obligations could be removed or mitigated. A number of respondents suggested mitigation may be more practical than removing joint and several liability, and suggested a number of alternative ways to achieve this. The Government will continue to explore these options. Any amendments needed to primary legislation on VAT will be brought forward in a Finance Bill, rather than the Financial Services (Banking Reform) Bill.

Depositor preference

Policy summary

2.40 Depositor preference will ensure that all deposits which are eligible for compensation under the FSCS ("insured deposits") will be made preferential debts, so that, in the event of the insolvency of a bank, they will rank ahead of the claims of other unsecured creditors. Since the FSCS will take on the claims of insured creditors, depositor preference should increase the amount which the FSCS is able to recover in the event of bank failure, reducing the amount required from surviving banks and consequently limiting the threat of contagion or contingent taxpayer liability. Preferring insured deposits will also mean remaining unsecured creditors would be exposed to greater losses in the event of bank failure, and so should be more alive to the need to monitor and manage the risk associated with their investment decisions; this is an expectation that cannot be made of insured depositors. All policy on depositor preference is dependent on the final outcome of the proposed RRD which is currently being negotiated. The UK will continue to engage with our European partners to ensure that the Directive continues to permit Member States to make deposits preferential debts.

Preference for debts other than deposits

2.41 In the white paper, the Government set out its intention to introduce insured depositor preference, and asked whether there was a case for other debts to be preferred alongside insured deposits. The debts considered were:

- a pension liabilities (specifically banks' liabilities to their own pension schemes);
- b overseas deposits (those that are equivalent to FSCS-eligible deposits, up to the FSCS coverage limit[6]); and
- c deposits placed by any particular groups, for example charities or local authorities.

2.42 Following further evaluation and analysis of consultation responses (outlined below), the Government deemed that there was not a sufficiently strong case for preferring any of these debts alongside insured deposits. To do so would dilute key aims of the policy – decreasing the amount the FSCS is able to recover on insolvency and reducing the misalignment between risk taken and reward in investment decisions – while increasing the exposure of other 'non-preferred' creditors to losses. Therefore the Government has decided – in line with the ICB recommendation – that only insured deposits should be preferred.

2.43 Respondents to the consultation did not submit views on whether there are compelling arguments against giving insured deposits *a* pari passu ranking with *currently* preferred debts. The Government does not propose to change the position of currently preferred debts.

A. Pension liabilities

2.44 Some respondents argued that pension liabilities should be classed as a preferential debt alongside insured deposits. The rationale for this was that pension trustees were likely to demand early reduction of pension deficits to limit their exposure to losses in the event of bank failure. However, little evidence was provided on the extent and costs of increased pension contributions, or on possible mitigations for banks to manage the transition while deficits are reduced.

2.45 Moreover, in contrast to deposits, pension deficits should not be a permanent feature in the longer term. As is the case in other sectors, banks should be working to close the liability gap of their pension schemes; and as depositor preference is not to be introduced until 2019, banks have a number of years to reach agreement with trustees on a manageable pathway to bring deficits down to mutually acceptable and sustainable levels. Providing preference to pension liabilities may send a signal that the Government is endorsing banks running large deficits in their schemes.

2.46 Finally, preferring bank pension schemes could prove distortive as it would put them in a significantly better position than pension schemes in other industry sectors. This would be particularly true of pension schemes in non-ring fenced banks, which are likely to hold only a relatively small share of insured deposits on their balance sheets.

B. Overseas deposits

2.47 Unlike (eligible) EEA deposits, deposits held in non-EEA branches of UK banks are not covered by the FSCS. Extending preference to these deposits would not therefore contribute to the core objective of insured depositor preference – namely preventing the transfer, via FSCS payout and levy, of risk from the creditors of an institution to the wider industry and, ultimately, taxpayers. Rather, the core argument for extending depositor preference to cover overseas

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[6] This is currently £85,000.

deposits (those that are equivalent to insured deposits covered by the FSCS) would be to avoid creating a perception that local creditors in non-EEA branches of UK banks are placed at a disadvantage relative to their EEA counterparts in a UK-led wind down.

2.48 However, the creation of ring-fenced banks, which will hold the substantial majority of insured deposits, should serve to neutralise this risk. This is because the intention is that ring-fenced banks are likely to have few, if any, branches outside the EEA, meaning that there will be a relatively minor subordination of overseas deposits, if any.

2.49 Furthermore, respondents have also shown little support or evidence that there will be concrete benefits from extending preference to non-EEA deposits. Rather, respondents have suggested extending preference in this way would serve to subordinate other unsecured 'non-preferred' creditors and potentially increase the costs of wholesale funding for banks, while doing little to further the policy's objectives. The point was also made that this could also undermine the viability of the business models of existing banks that hold large volumes of overseas deposits, and it may also complicate resolutions in situations where data on local depositor guarantee scheme coverage does not align with UK preference terms.

C. Other groups of depositors

2.50 A number of respondents argued that there is a case for extending preference beyond insured deposits to deposits placed by other groups, for example charities. Arguments put forward include that it is not universally true that all non-retail depositors are sophisticated investors; that many deposits should not be considered as investments (for example if they are public donations); and that limiting preference to only insured deposits may increase the risk borne by (or compromise the investment earnings potential of) organisations dedicated to bringing about wider societal benefits.

2.51 There are considerable drawbacks in extending the scope of preference to other groups of creditors, such as the dilution of the benefits of preference to the FSCS, and the effect of increasing the exposure of other non-preferred groups to losses in the event the bank fails. The wider the extension of preference (for example to multiple groups), the greater the impact of these drawbacks will be. The Government has carefully considered the arguments made in favour of preferring other groups of depositors, but takes the view that no group or sector stands out as an exceptional case. Organisations that channel public or donor funds to deliver societal benefits include, among others, schools, universities, charities, police authorities, and local authorities, and the larger ones will be more likely to have the resources to make multi-million pound investments on the basis of maximising return for a given level of risk (rather than purely holding funds prior to onward transfer). Such organisations are likely to be at least as well positioned to monitor and manage risk as many other groups of senior unsecured creditors who would stand to be subordinated if preference were extended.

2.52 Importantly, however, it is expected that FSCS coverage will be extended (under the Proposal for a Directive on Deposit Guarantee Schemes[7]) to include currently uncovered deposits. This will mean that all individuals and most organisations[8] will be eligible for FSCS protection for amounts deposited up to the coverage limit.[9] Where individuals and organisations hold sums beyond the FSCS limit, the Government believes it is right that they should monitor and manage the risk in where they place deposits, as all other unsecured creditors must do (including individuals and small businesses).

[7] This can be viewed at http://ec.europa.eu/internal_market/bank/docs/guarantee/20100712_proposal_en.pdf.

[8] Financial companies and public authorities are not eligible for compensation under the draft proposal.

[9] This is currently £85,000 in the United Kingdom.

2.53 The Government notes that while some respondents have proposed that preference should be extended to particular groups on the basis of government priorities other than financial stability (for example wider societal benefits), there are those who argue that this might set a dangerous precedent, and could result in investors losing confidence in the stability and coherence of the UK financial policy environment.

Framework for implementing Primary Loss Absorbency Capacity (PLAC) requirements

Policy summary

2.54 Banks should be required to hold sufficient loss-absorbing capacity to ensure that they are more resilient against failure and that, if they do fail, losses can be borne by their shareholders and uninsured unsecured creditors rather than falling on the taxpayer. The Government agreed with the ICB that UK ring-fenced banks and UK-headquartered globally systemically important banks (G-SIBs) should be required to hold PLAC of up to 17 per cent of RWAs.[10] The Government believes that there should also be a consistent minimum requirement for loss-absorbing capacity across the EU.

2.55 The composition of loss-absorbing capital has been set out in the Basel III accords, and the capital requirements will be implemented across the EU through the CRD IV/CRR; the requirement for banks to hold 'minimum eligible liabilities' (which includes capital and credibly loss-absorbing debt instruments) is set out in the RRD proposal.

2.56 As set out in the white paper, the Government expects the RRD to require Member States to introduce a credible and practicable bail-in power in their bank and investment firm resolution frameworks. It also expects the RRD to include a minimum eligible liabilities requirement. This should serve to ensure that debt instruments which qualify towards the minimum eligible liabilities requirements, among others, can credibly be made to bear losses.

2.57 Having considered the white paper consultation responses and carried out further analysis, the Government is of the view that the categories for PLAC (and for a European minimum eligible liabilities requirement) should be regulatory capital, and subordinated debt and senior unsecured debt with at least twelve months' term remaining and which the resolution authorities are confident could be bailed-in, as the ICB recommended.

PLAC requirements on UK banks

2.58 As the ICB noted, the UK has, as a percentage of GDP, one of the largest banking sectors in the world. So that it can effectively manage this risk, the Government is keen to ensure that the RRD enables Member States to require their banks to hold a sufficient amount of instruments that can credibly absorb losses in a resolution, in a manner that gives due regard to consistency of implementation and supports a level playing field across the Single Market. Developments are ongoing, but the Government believes that the most systemic cross-border banks domiciled in Europe should hold loss-absorbing instruments (both regulatory capital and loss-absorbing debt) equivalent to those levels the Government is proposing for the UK.

PLAC requirements in relation to overseas entities of UK banks

2.59 The Government does not believe it is appropriate to set PLAC requirements against RWAs held in non-EEA operations of UK-headquartered banks, where they pose no likely threat to UK or EEA financial stability. Such an approach is likely to be disproportionate in terms of the

[10] See white paper page 33 for more details.

burden imposed on banks and possible associated impacts on other public policy objectives, while potentially being counterproductive as it may create an incentive for UK banks to re-domicile in non-EEA countries, while leaving behind much of the risk that the EEA entities of the group might pose. In order to ensure that a prudent balance can be found between these risks and objectives, the Government proposes to take a power that will enable it to specify by order any additional conditions or factors to which the regulator must have regard when setting PLAC requirements for UK-headquartered G-SIBs. These conditions or factors will be designed to ensure that the framework for applying requirements on firms is calibrated (on the basis of risk to UK or EEA financial stability) to take into account the proportionality of including non-EEA entities in PLAC calculations. Work to identify the conditions for exemption is in progress as part of coordinated international efforts, including through discussions between regulators, resolution authorities and governments, to identify and plan for the removal of barriers to resolving cross-border banks.

Legislation

2.60 The draft Bill will give the Treasury a power to make an order regulating the way in which the regulator may exercise its powers under FSMA to impose debt requirements on banks (including ring-fenced banks). The Government considers that it will be possible to use this power to implement loss absorbency requirements, as currently proposed in the RRD in relation to eligible liabilities, in the UK, and to set rules in relation to quantity, quality and additional conditions or factors that the regulator must have regard to when calculating PLAC requirements, in keeping with the Government's intentions.

FSMA fees

Policy summary

2.61 The Bill will amend FSMA to allow the Treasury to direct the regulators (the PRA, the FCA and the Bank of England) to charge the financial services firms that they regulate a fee in respect of certain expenses incurred by the Treasury. This will only apply to those expenses incurred in connection with the membership of certain international organisations; however, the expenses concerned must be attributable to the functions of the organisation which relate to financial stability or financial services.

2.62 The detail of the organisations which are relevant to this power, and the detail of what expenses can be recovered, will be set out in secondary legislation. This would mean that the Treasury could recover from the financial services industry expenses it incurs in relation to work within international organisations in connection with financial stability or financial services, such as the costs associated with the membership of international financial stability fora like the FSB. The growing importance of the FSB and other international bodies as forums for setting international standards which promote financial stability or relate to financial services make it vital that the UK can continue to be well represented in these forums. The Government expects costs to industry to be minimal.

FSCS governance reform

Policy summary

2.63 The Government proposes to include provisions in the Bill to impose new statutory duties on the FSCS, including requiring it to: operate the scheme swiftly and efficiently for the benefit of claimants;mitigate taxpayer costs; and provide the Treasury with accounting and management information. It will also make provision for the statutory appointment of the chief executive of the scheme manager as an Accounting Officer. The clauses will be included in the Bill when it is introduced in Parliament next year.

2.64 The Office of National Statistics has reclassified the FSCS as a central government body, and consequently FSCS has been integrated into HM Treasury's Group accounts. These provisions will ensure the Treasury has access to the information necessary for its Principal Accounting Officer to be assured of high standards of regularity and propriety at FSCS; they will also clarify responsibilities and ensure value for money for the taxpayer.

2.65 The changes will not impact upon the wider financial services industry. The FSA and, in due course, the PRA and FCA will continue to be responsible for making the rules under which the compensation scheme operates, including the FSCS's arrangements for setting their annual levy on the financial services industry. HM Treasury will continue to have no power to intervene in the FSCS's day to day affairs.

Payments reform

Policy summary

2.66 The Government intends to enhance the regulation of payments networks in the UK, with the aim of ensuring that:

- UK payments networks operate for the benefit of endusers including consumers;
- the UK payments industry promotes and develops new and existing payments networks;
- there is more competition in payments networks by permitting open access for participants and potential participants on reasonable commercial terms;and
- UK payment networks are stable, reliable and efficient.

2.67 The Government's proposals are designed to respond to concerns about the operation of the Payments Council whose decision-making is dominated by big banks. The proposals follow, in particular, the Payment Council's decision to abolish cheques and the subsequent Treasury Select Committee enquiry. The background is set out in more detail in the consultation, *Setting the strategy for UK payments* published in June 2012 which considers:

- enhanced self-regulation through the Payments Council;
- creation of a Payments Strategy Board to set strategy across the UK payments industry; and
- creation of a new regulator to oversee payments structures.

As this consultation closes on October 10 and final policy decisions have not been taken, there are no clauses on payments reform in the draft ill and will not undergo pre-legislative scrutiny. The clauses will be included in the Bill when it is introduced in Parliament early next year.

3 Draft Bill

3.1 This section contains the draft Bill.

Draft Financial Services (Banking Reform) Bill

CONTENTS

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Make provision for protecting the continuity of the provision of financial services whose interruption could affect financial stability; to make provision for the amounts owed in respect of certain deposits to be treated as preferential debts on insolvency; to make provision about the recovery of expenses incurred by the Treasury in connection with international organisations concerned with financial stability or financial services; and for connected purposes.

BE IT ENACTED by the Queen's most Excellent Majesty, by and with the advice and consent of the Lords Spiritual and Temporal, and Commons, in this present Parliament assembled, and by the authority of the same, as follows:—

Ring-fencing

1 Objectives of Financial Conduct Authority

(1) In section 1B of FSMA 2000 (the FCA's general duties)—

(a) in subsection (3) after paragraph (c) insert—

"(d) in relation to the matters mentioned in section 1EA(2), the continuity objective (see section 1EA)."

(b) for subsection (4) substitute—

"(4) The FCA must discharge its general functions in a way which promotes effective competition in the interests of consumers, but is required to do so only so far as this is compatible with—

(a) acting in a way which advances the consumer protection objective or the integrity objective, and

(b) in relation to the matters mentioned in section 1EA(2), acting a way which advances the continuity objective."

(2) After section 1E of FSMA 2000 insert—

"1EA Continuity objective

(1) In relation to the matters mentioned in subsection (2), the continuity objective is: protecting the continuity of the provision in the United Kingdom of core services (see section 142C).

(2) Those matters are—
(a) Part 9B (ring-fencing);
(b) ring-fenced bodies (see section 142A);
(c) bodies corporate incorporated in the United Kingdom which are members of a group that includes a ring-fenced body;
(d) applications under Part 4A which, if granted, would result in a person becoming a ring-fenced body.

(3) The FCA's continuity objective is to be advanced primarily by—
(a) seeking to ensure that the business of ring-fenced bodies is carried on in a way that avoids any adverse effect on the continuity of the provision in the United Kingdom of core services,
(b) seeking to ensure that the business of ring-fenced bodies is protected from risks (arising in the United Kingdom or elsewhere) that could adversely affect the continuity of the provision in the United Kingdom of core services, and
(c) seeking to minimise the risk that the failure of a ring-fenced body could adversely affect the continuity of the provision in the United Kingdom of core services."

2 Objectives of Prudential Regulation Authority

(1) In section 2B of FSMA 2000 (the PRA's general objective), in subsection (6), after "sections" insert "2BA,".

(2) After that section insert—

"2BA Continuity objective

(1) In discharging its general functions so far as relating to any of the matters mentioned in subsection (2), the PRA must, so far as is reasonably possible, act in a way—
(a) which is compatible with its continuity objective, and
(b) which the PRA considers most appropriate for the purpose of advancing its general objective or its continuity objective.

(2) Those matters are—
(a) Part 9B (ring-fencing);
(b) ring-fenced bodies (see section 142A);
(c) bodies corporate incorporated in the United Kingdom that are members of a group that includes a ring-fenced body;
(d) applications under Part 4A which, if granted, would result in a person becoming a ring-fenced body.

(3) The PRA's continuity objective is: protecting the continuity of the provision in the United Kingdom of core services (see section 142C).

(4) The PRA's continuity objective is to be advanced primarily by—
(a) seeking to ensure that the business of ring-fenced bodies is carried on in a way that avoids any adverse effect on the continuity of the provision in the United Kingdom of core services,
(b) seeking to ensure that the business of ring-fenced bodies is protected from risks (arising in the United Kingdom or elsewhere) that could adversely affect the continuity of the provision in the United Kingdom of core services, and
(c) seeking to minimise the risk that the failure of a ring-fenced body could adversely affect the continuity of the provision in the United Kingdom of core services."

(3) In section 2C of FSMA 2000 (the insurance objective), in subsection (1)(a), after "its general objective" insert ", its continuity objective".

(4) In section 2D of FSMA 2000 (other objectives), in subsection (3)(a), after "its general objective" insert ", its continuity objective".

(5) In section 2E of FSMA 2000 (interpretation of references to objectives), in subsection (3)(a), after paragraph (a) insert—
"(aa) so far as the function relates to any of the matters mentioned in section 2BA(2), is a reference to its general objective and its continuity objective;".

3 Relationship between regulators

(1) In section 3E of FSMA 2000 (memorandum of understanding), in subsection (3), before paragraph (a) insert—
"(za) the exercise by each regulator of its general functions in a way that advances that regulator's continuity objective;".

(2) In section 3I of FSMA 2000 (power of PRA to require FCA to refrain from specified action), in subsection (4)—
(a) at the end of paragraph (a), omit "or", and
(b) at the end of paragraph (b) insert "or
(c) threaten the continuity of core services provided in the United Kingdom."

4 Ring-fencing of certain activities

(1) After Part 9A of FSMA 2000 insert—

"PART 9B

RING-FENCING

Introductory

142A "Ring-fenced body"

(1) In this Act "ring-fenced body" means a UK institution which has a Part 4A permission relating to one or more core activities (see section 142B).

(2) But "ring-fenced body" does not include—

(a) a building society within the meaning of the Building Societies Act 1986, or

(b) a UK institution of a class exempted by order made by the Treasury.

(3) An order under subsection (2)(b) may be made in relation to a class of UK institution only if the Treasury are of the opinion that the exemption conferred by the order would not be likely to have a significant adverse effect on the continuity of the provision in the United Kingdom of core services.

(4) An order under subsection (2)(b) may provide for the exemption to be subject to conditions.

(5) In this section "UK institution" means a body corporate incorporated in the United Kingdom.

142B Core activities

(1) References in this Act to a "core activity" are to be read in accordance with this section.

(2) The regulated activity of accepting deposits (whether carried on in the United Kingdom or elsewhere) is a core activity unless it is carried on in circumstances specified by order made by the Treasury.

(3) An order under subsection (2) may be made only if the Treasury are of the opinion that it is not necessary for either of the following purposes that the regulated activity of accepting deposits should be a core activity when carried on in the specified circumstances.

(4) Those purposes are—

(a) to secure an appropriate degree of protection for the depositors concerned, or

(b) to protect the continuity of the provision in the United Kingdom of services provided in the course of carrying on the regulated activity of accepting deposits.

(5) The Treasury may by order provide for a regulated activity other than that of accepting deposits to be a core activity, either generally or when carried on in circumstances specified in the order.

(6) An order under subsection (5) may be made only if the Treasury are of the opinion—

(a) that an interruption of the provision of services provided in the United Kingdom in the carrying on of the regulated activity concerned could adversely affect the stability of the UK financial system or of a significant part of that system, and

(b) that the continuity of the provision of those services can more effectively be protected by treating the activity as a core activity.

142C Core services

(1) References in this Act to "core services" are to be read in accordance with this section.

(2) The following are core services—

(a) facilities for the accepting of deposits or other payments into an account which is provided in the course of carrying on the core activity of accepting deposits;
(b) facilities for withdrawing money or making payments from such an account;
(c) overdraft facilities in connection with such an account.

(3) The Treasury may by order provide that any other specified services provided in the course of carrying on the core activity of accepting deposits are also to be core services.

(4) An order under subsection (5) of section 142B which provides for an activity other than that of accepting deposits to be a core activity must specify the services in relation to which the Treasury are of the opinion mentioned in subsection (6)(a) and (b) of that section; and those services are also to be core services.

142D Excluded activities

(1) References in this Act to an "excluded activity" are to be read in accordance with this section.

(2) The regulated activity of dealing in investments as principal (whether carried on in the United Kingdom or elsewhere) is an excluded activity unless it is carried on in circumstances specified by order made by the Treasury.

(3) An order under subsection (2) may be made only if the Treasury are of the opinion that allowing ring-fenced bodies to deal in investments as principal in the specified circumstances would not be likely to result in any significant adverse effect on the continuity of the provision in the United Kingdom of core services.

(4) The Treasury may by order provide for an activity other than the regulated activity of dealing in investments as principal to be an excluded activity, either generally or when carried on in circumstances specified in the order.

(5) An activity to which an order under subsection (4) relates—
(a) need not be a regulated activity, and
(b) may be an activity carried on in the United Kingdom or elsewhere.

(6) In deciding whether to make an order under subsection (4) in relation to any regulated activity, the Treasury must—
(a) have regard to the risks to which a ring-fenced body would be exposed if it carried on the activity concerned, and
(b) consider whether the carrying on of that activity by a ring-fenced body would make it more likely that the failure of the body would have an adverse effect on the continuity of the provision in the United Kingdom of core services.

(7) An order under subsection (4) may be made only if the Treasury are of the opinion that the making of the order is necessary or expedient for the purpose of protecting the continuity of the provision in the United Kingdom of core services.

142E Power of Treasury to impose prohibitions

(1) The Treasury may by order prohibit ring-fenced bodies from—

(a) entering into transactions of a specified kind or with persons falling within a specified class;

(b) establishing a branch in a specified country or territory;

(c) holding in specified circumstances shares or voting power in other companies of a specified description.

(2) In deciding whether to make an order under this section imposing a prohibition, the Treasury must—

(a) have regard to the risks to which a ring-fenced body would be exposed if it did the thing to which the prohibition relates, and

(b) consider whether the doing of that thing by a ring-fenced body would make it more likely that the failure of the body would have an adverse effect on the continuity of the provision in the United Kingdom of core services.

(3) An order under this section may be made only if the Treasury are of the opinion that the making of the order is necessary or expedient for the purpose of protecting the continuity of the provision in the United Kingdom of core services.

(4) An order under this section may in particular—

(a) provide for any prohibition to be subject to exemptions specified in the order;

(b) provide for any exemption to be subject to specified conditions.

142F Orders under sections 142A, 142B, 142D or 142E

(1) An order made under section 142A, 142B, 142D or 142E may—

(a) confer powers on the Treasury or on a regulator;

(b) authorise or require the making of rules by a regulator for the purposes of, or connected with, any provision of the order;

(c) authorise the making of other instruments for the purposes of, or connected with, any provision of the order.

(2) If the order confers powers on a regulator or authorises or requires the making of rules or other instruments by a regulator, the order may also—

(a) impose conditions on the exercise of any power conferred on the regulator;

(b) impose consultation requirements on the regulator;

(c) make the exercise of a power by the regulator subject to the consent of the Treasury.

Ring-fenced bodies not to carry on excluded activities or contravene prohibitions

142G Ring-fenced bodies not to carry on excluded activities or contravene prohibitions

(1) A ring-fenced body which—

(a) carries on an excluded activity or purports to do so, or

(b) contravenes any provision of an order under section 142E, is to be taken to have contravened a requirement imposed on the body by the appropriate regulator under this Act.

(2) The contravention does not—

(a) make a person guilty of an offence;

(b) make a transaction void or unenforceable;

(c) (subject to subsection (3)) give rise to any right of action for breach of statutory duty.

(3) In such cases as the Treasury may specify by order, the contravention is actionable at the suit of a person who suffers loss as a result of the contravention, subject to the defences and other incidents applying to actions for breach of statutory duty.

(4) In this section "the appropriate regulator" means—

(a) in relation to a ring-fenced body which is a PRA-authorised person, the PRA;

(b) in relation to any other ring-fenced body, the FCA.

Ring-fencing rules

142H Ring-fencing rules

(1) In the exercise of its power to make general rules, the appropriate regulator must in particular make rules ("ring-fencing rules") applying to ring-fenced bodies for the purpose of ensuring—

(a) that the carrying on of core activities by a ring-fenced body is not adversely affected by the acts or omissions of other persons, and

(b) that any ring-fenced body which is a member of a group is able to act independently of other members of the group in carrying on the business of the ring-fenced body.

(2) Subject to any provision made by order under section 142E, ring-fencing rules may include provision—

(a) restricting the extent of the shares or voting power that a ring-fenced body may hold in another company;

(b) requiring a ring-fenced body to make arrangements to ensure the effective provision to the ring-fenced body of services and facilities that it requires in relation to the carrying on of a core activity.

(3) In relation to a ring-fenced body that is a member of a group, ring-fencing rules must—

(a) make provision of the kind mentioned in subsection (2)(a) and (b) unless such provision is made by order under section 142E;

(b) restrict the power of the ring-fenced body to enter into contracts with other members of the group otherwise than on arm's length terms;

(c) restrict the payments that the ring-fenced body may make (by way of dividend or otherwise) to other members of the group;

(d) make provision requiring the disclosure to the appropriate regulator of information relating to transactions between the ring-fenced body and other members of the group;

(e) make provision about the corporate governance of the ring-fenced body with a view to securing as far as practicable its ability to act independently of other members of the group.

(4) In this section “shares” and “voting power” have the meaning given in section 422.

(5) In this section “the appropriate regulator” means—

(a) in relation to a ring-fenced body which is a PRA-authorised person, the PRA;

(b) in relation to any other ring-fenced body, the FCA.

142I Review of ring-fencing rules

(1) The PRA must carry out reviews of its ring-fencing rules.

(2) The first review must be completed before the end of the period of 5 years beginning with the date on which the first ring-fencing rules come into force.

(3) Subsequent reviews must be completed before the end of the period of 5 years beginning with the date on which the previous review was completed.

(4) The PRA must give the Treasury a report of each review.

(5) The Treasury must lay a copy of the report before Parliament.

(6) The PRA must publish the report in such manner as it thinks fit.

(7) If (because any ring-fenced body is not a PRA-authorised person) section 142H has the effect of requiring the FCA to make ring-fencing rules, subsections (1) to (6) apply to the FCA as they apply to the PRA.

Powers of Treasury

142J Power in relation to loss-absorbency requirements

(1) The Treasury may by order make provision about the exercise by either regulator of its powers under this Act, so far as they are (apart from the order) capable of being exercised in relation to a relevant body so as to require the relevant body—

(a) to issue any debt instrument, or

(b) to ensure that any part of the relevant body’s debt consists of debt owed by it in respect of debt instruments, or debt instruments of a particular kind.

(2) A “relevant body” is—

(a) a ring-fenced body,

(b) any other body corporate that has a Part 4A permission relating to the regulated activity of accepting deposits, or

(c) a body corporate that is a member of the group of a body falling within paragraph (a) or (b).

(3) “Debt instrument” means—

(a) a bond,

(b) any other instrument creating or acknowledging a debt, or

(c) an instrument giving rights to acquire a debt instrument.

(4) An order under this section may in particular—
(a) require a regulator to exercise its functions so as to require relevant bodies do either or both of the things mentioned in subsection (1);
(b) limit the extent to which a regulator may require a relevant body's debt to consist of debt owed in respect of debt instruments or of debt instruments of a kind specified in the order;
(c) require the regulator to consult the Treasury before imposing a requirement in accordance with the order in a particular case;
(d) confer power on the Treasury to issue directions to the regulator as to specified matters.

142K Power to amend legislation relating to groups

(1) This section applies where a provision of primary or secondary legislation (whenever passed or made) has the effect of imposing liability on a body corporate that is a member of a group on the basis of anything done or omitted by another member of the group.

(2) The Treasury may by order make such amendments of the legislation as appear to them to be necessary or expedient for the purpose of ensuring that the carrying on of core activities by a ring-fenced body that is a member of a group is not adversely affected by things done or omitted by other members of the group.

Interpretation

142L Interpretation of Part 9B

In this Part, any reference to—
(a) the regulated activity of accepting deposits, or
(b) the regulated activity of dealing in investments as principal,
is to be read in accordance with Schedule 2, taken with any order under section 22."

(2) In section 417 of FSMA 2000 (definitions), in subsection (1)—
(a) after the definition of "control of information rules" insert—
""core activities" has the meaning given in section 142B;
"core services" has the meaning given in section 142C;",
(b) after the definition of "ESMA" insert—
""excluded activities" has the meaning given in section 142D;", and
(c) after the definition of "regulator" insert—
""ring-fenced body" has the meaning given in section 142A;
"ring-fencing rules" has the meaning given in section 142H;".

5 Banking business transfer schemes

(1) Section 106 of FSMA 2000 (banking business transfer schemes) is amended as follows.

(2) After subsection (2) insert—

"(2A) A scheme is also a banking business transfer scheme if it—

(a) is one under which the whole or part of the business carried on by a UK authorised person who has permission which includes permission to carry on one or more core activities ("the authorised person concerned") is to be transferred to another body ("the transferee"),

(b) is being made for the purpose of avoiding a ring-fencing contravention that would or might arise if the whole of the business of the authorised person concerned continued to be carried on by the same person, and

(c) is not an excluded scheme."

(3) In subsection (4), after "subsection (2)(a)" insert "or (2A)(a)".

(4) After subsection (4) insert—

"(4A) "Ring-fencing contravention" means—

(a) a contravention within section 142G (ring-fenced bodies not to carry on excluded activities or contravene prohibition), or

(b) a contravention of ring-fencing rules."

(5) In section 107 of FSMA 2000 (application for order sanctioning transfer scheme), after subsection (2) insert—

"(2A) If the application relates to a banking business transfer scheme falling within section 106(2A) (whether or not also falling within section 106(1)) the application may only be made with the consent of the PRA."

6 Building societies: power to make provision about ring-fencing

(1) The Treasury may by regulations—

(a) make provision in relation to building societies for purposes corresponding to those of any provision made, in relation to authorised persons other than building societies, by or under any provision of Part 9B of FSMA 2000 (ring-fencing) apart from section 142J, and

(b) provide for the application of the relevant continuity objective in relation to the exercise by the FCA or the PRA of any function conferred on it by or under provision made pursuant to paragraph (a).

(2) The regulations may, in particular—

(a) amend the Building Societies Act 1986;

(b) apply any of the provisions contained in, or made under, Part 9B of FSMA 2000, with such modifications as the Treasury consider appropriate;

(c) authorise the making of rules or other instruments by the FCA or the PRA for the purposes of, or connected with, any provision made by the regulations;

(d) confer functions on the FCA or the PRA;

(e) make such consequential provision including amendments of any enactment as the Treasury consider appropriate.

(3) Regulations under this section are to be made by statutory instrument.

(4) A statutory instrument containing regulations under this section may not be made unless a draft of the instrument has been laid before and approved by a resolution of each House of Parliament.

(5) In this section—

"building society" has the same meaning as in the Building Societies Act 1986;

"the relevant continuity objective" means—

(a) in the case of functions exercisable by the FCA, the continuity objective set out in section 1EA of FSMA 2000, or

(b) in the case of functions exercisable by the PRA, the continuity objective set out in section 2BA of that Act.

Depositor preference

7 Preferential debts: Great Britain

(1) In Schedule 6 to the Insolvency Act 1986 (categories of preferential debts) after paragraph 15A insert—

"Category 7: Deposits covered by Financial Services Compensation Scheme

15B So much of any amount owed at the relevant date by the debtor in respect of an eligible deposit as does not exceed the compensation that would be payable in respect of the deposit under the Financial Services Compensation Scheme to the person or persons to whom the amount is owed.

Interpretation for Category 7

15C (1) In paragraph 15B "eligible deposit" means a deposit in respect of which the person, or any of the persons, to whom it is owed would be eligible for compensation under the Financial Services Compensation Scheme.

(2) For this purpose a "deposit" means rights of the kind described in—

(a) paragraph 22 of Schedule 2 to the Financial Services and Markets Act 2000 (deposits), or

(b) section 1(2)(b) of the Dormant Bank and Building Society Accounts Act 2008 (balances transferred under that Act to authorised reclaim fund)."

(2) In section 386 of the Insolvency Act 1986 (categories of preferential debt), in subsection (1), after "production" insert "; deposits covered by Financial Services Compensation Scheme".

(3) In Part 1 of Schedule 3 to the Bankruptcy (Scotland) Act 1985 (list of preferred debts), after paragraph 6A insert—

"Deposits covered by Financial Services Compensation Scheme

6B So much of any amount owed at the relevant date by the debtor in respect of an eligible deposit as does not exceed the compensation that would be payable in respect of the deposit under the Financial

Services Compensation Scheme to the person or persons to whom the amount is owed."

(4) In Part 2 of Schedule 3 to the Bankruptcy (Scotland) Act 1985 (interpretation of Part 1), after paragraph 9 insert—

"Meaning of eligible deposit

9A (1) In paragraph 6B "eligible deposit" means a deposit in respect of which the person, or any of the persons, to whom it is owed would be eligible for compensation under the Financial Services Compensation Scheme.

(2) For this purpose a "deposit" means rights of the kind described in paragraph 22 of Schedule 2 to the Financial Services and Markets Act 2000 (deposits)."

8 Preferential debts: Northern Ireland

(1) The Insolvency (Northern Ireland) Order 1989 (S.I. 1989/2405 (N.I. 19)) is amended as follows.

(2) In Schedule 4 (categories of preferential debts), after paragraph 17 insert—

"Category 7: Deposits covered by Financial Services Compensation Scheme

18 So much of any amount owed at the relevant date by the debtor in respect of an eligible deposit as does not exceed the compensation that would be payable in respect of the deposit under the Financial Services Compensation Scheme to the person or persons to whom the amount is owed.

Interpretation for Category 7

19 (1) In paragraph 18 "eligible deposit" means a deposit in respect of which the person, or any of the persons, to whom it is owed would be eligible for compensation under the Financial Services Compensation Scheme.

(2) For this purpose a "deposit" means rights of the kind described in—

(a) paragraph 22 of Schedule 2 to the Financial Services and Markets Act 2000 (deposits), or

(b) section 1(2)(b) of the Dormant Bank and Building Society Accounts Act 2008 (balances transferred under that Act to authorised reclaim fund)."

(3) In Article 346 (categories of preferential debt), in paragraph (1), after "production" insert "; deposits covered by Financial Services Compensation Scheme".

Fees to meet Treasury expenditure

9 Fees to meet Treasury expenditure

After section 410 of FSMA 2000 insert—

"Fees to meet Treasury expenses

410A Fees to meet certain expenses of the Treasury

(1) The Treasury may by regulations—

(a) enable the Treasury from time to time by direction to require the FCA, the PRA or the Bank of England (each a "regulator") to require the payment of fees by relevant persons, or such class of relevant person as may be specified in, or determined by the regulator in accordance with, the direction, for the purpose of meeting relevant expenses;

(b) make provision about how the regulator to which a direction is given is to comply with the direction;

(c) require the regulator to pay to the Treasury, by such time or times as may be specified in the direction, the amount of any fees received by the regulator.

(2) "Relevant expenses" are expenses (including any expenses of a capital nature) that are incurred by the Treasury in connection with, or for the purposes of, United Kingdom membership of, or Treasury participation in, a prescribed international organisation, so far as those expenses are in the opinion of the Treasury attributable to functions of the organisation which relate to financial stability or financial services.

(3) The regulations must provide for the charging of fees in pursuance of a direction given under the regulations to the FCA or the PRA to be by rules made by that regulator.

(4) The provisions of Chapter 2 of Part 9A apply to rules of the FCA or the PRA providing for the charging of fees in pursuance of a direction given under the regulations—

(a) in the case of the FCA, as they apply to rules relating to the payment of fees under paragraph 20 of Schedule 1ZA;

(b) in the case of the PRA, as they apply to rules relating to the payment of fees under paragraph 28 of Schedule 1ZB.

(5) Paragraph 32(1) of Schedule 17A applies to the charging of fees by the Bank of England in pursuance of a direction given to the Bank under the regulations.

(6) The regulations may in particular—

(a) make provision about what is, or is not, to be regarded as an expense;

(b) specify requirements that the Treasury must comply with before giving a direction;

(c) enable a direction to be varied or revoked by a subsequent direction;

(d) confer functions on a regulator.

(7) An amount payable to a regulator as a result of—

(a) any provision of rules made by the FCA or the PRA as a result of the regulations, or

(b) the imposition of fees by the Bank of England as a result of a direction given under the regulations to the Bank,

may be recovered as a debt due to the regulator.

(8) "Relevant persons" means—

(a) in the case of a direction given to the PRA, PRA-authorised persons;

(b) in the case of a direction given to the FCA, authorised persons and recognised investment exchanges who (in either case) are not PRA-authorised persons;

(c) in the case of a direction given to the Bank of England, recognised clearing houses, other than those falling within paragraph (a) or (b).

(9) This section is subject to section 410B.

410B Directions in pursuance of section 410A

(1) In this section "a fees direction" means a direction given by the Treasury as a result of regulations under section 410A.

(2) Before giving a fees direction to the FCA, the PRA or the Bank of England (each a "regulator"), the Treasury must consult the regulator concerned.

(3) A fees direction must—

(a) be in writing;

(b) except in the case of a direction that revokes a previous direction or a direction that varies a previous direction without affecting the total amount intended to be raised by the fees, specify the total amount intended to be raised by the fees to be charged by the regulator and explain how that amount is calculated;

(c) contain such other information as may be prescribed.

(4) As soon as practicable after giving a fees direction, the Treasury must lay before Parliament a copy of the direction."

Parliamentary control of statutory instruments under FSMA 2000

10 Amendments of section 429 of FSMA 2000

(1) Section 429 of FSMA 2000 (Parliamentary control of statutory instruments) is amended as follows.

(2) In subsection (1)(a) (orders subject to affirmative procedure), after "55C," insert "142K,".

(3) After subsection (2) insert—

"(2A) Regulations to which subsection (2B) applies are not to be made unless a draft of the regulations has been laid before Parliament and approved by a resolution of each House.

(2B) This subsection applies to regulations which contain provisions made under section 410A, other than provisions made only by virtue of subsection (2) of that section.”

(4) In subsection (3), for “or (5)” substitute “, (5) or (5A)”, and

(5) After subsection (5) insert—

“(5A) This subsection applies to an order under section 142A(2)(b) if—

(a) it is the first order to be made, or to contain provisions made, under that provision, or

(b) it contains provisions restricting or removing an exemption provided by an earlier order made under that provision.”

Final provisions

11 Interpretation

In this Act—

“the FCA” means the Financial Conduct Authority;

“FSMA 2000” means the Financial Services and Markets Act 2000;

“the PRA” means the Prudential Regulation Authority”.

12 Transitional provisions and savings

(1) The Treasury may by order made by statutory instrument make such provision as they consider necessary or expedient for transitory, transitional or saving purposes in connection with the commencement of any provision made by or under this Act.

(2) An order under this section may—

(a) confer functions on the FCA or the PRA;

(b) modify, exclude or apply (with or without modifications) any enactment (including any provision of, or made under, this Act).

(3) A statutory instrument containing an order under this section is subject to annulment in pursuance of a resolution of either House of Parliament.

13 Extent, commencement and short title

(1) This Act extends to England and Wales, Scotland and Northern Ireland.

(2) Sections 11 and 12 and this section come into force on the day on which this Act is passed.

(3) The remaining provisions of this Act come into force on such day as the Treasury may by order made by statutory instrument appoint.

(4) Different days may be appointed for different purposes.

(5) This Act may be cited as the Financial Services (Banking Reform) Act 2013.

4 Explanatory notes

4.1 This section contains the explanatory notes.

These notes refer to the Financial Services (Banking Reform) Bill as published in draft for pre-legislative scrutiny on 12 October 2012

DRAFT FINANCIAL SERVICES (BANKING REFORM) BILL

EXPLANATORY NOTES

INTRODUCTION

1. These Explanatory Notes relate to the Financial Services (Banking Reform) Bill as published in draft on 12 October 2012. They have been prepared by HM Treasury in order to assist the reader of the draft Bill and to help inform debate on it. They do not form part of the draft Bill and have not been endorsed by Parliament.

2. The notes need to be read in conjunction with the draft Bill. They are not, and are not meant to be, a comprehensive description of the draft Bill. So where a clause or part of a clause does not seem to require any explanation or comment, none is given.

SUMMARY AND BACKGROUND

Background

3. The Government is committed to implementing recommendations of the Independent Commission on Banking (ICB), which was established in June 2010 and tasked with making recommendations on structural and related non-structural reforms to the banking system:

> "The Commission will make recommendations covering both:
>
> - Structural measures to reform the banking system and promote stability and competition, including the complex issue of separating retail and investment banking functions; and
> - Related non-structural measures to promote stability and competition in banking for the benefit of consumers and businesses.
>
> In considering these measures the Commission will have regard to the legal and operational requirements of implementing the options under consideration, and the importance of generating practical recommendations. It will also take into account the findings of ongoing EU and international work, and inform the UK Government's approach to international discussions on the financial system.
>
> The Commission will also have regard to the Government's wider goals of

financial stability and creating an efficient, open, robust and diverse banking sector, with specific attention paid to the potential impact of its recommendations on:

- Financial stability;
- Lending to UK consumers and businesses and the pace of economic recovery;
- Consumer choice;
- The competitiveness of the UK financial and professional services sectors and the wider UK economy; and
- Risks to the fiscal position of the Government."[1]

4. The ICB presented its final recommendations to Government on 12 September 2011. The Government published its initial response and plans for implementation on 19 December 2011 in Cm 8252 '*Government response to the Independent Commission on Banking*'. The Government developed its proposals further and set them out in a White Paper, Cm 8356 '*Banking reform: delivering stability and supporting a sustainable economy*'. This set out more detail on the policy design was followed by a further period of consultation. Copies of the relevant documents, including these consultation documents, are available on the Treasury's website (www.hm-treasury.gov.uk) and the website of the ICB, (bankingcommission.independent.gov.uk).

Summary

5. The draft Bill makes four changes in relation to the banking and financial services sector.

6. Firstly, the draft Bill provides additional protection to vital banking services (those services related to the acceptance of deposits) by introducing ring-fencing. Certain banks carrying on core activities will be required to be ring-fenced, and will be prohibited from carrying on activities (excluded activities) which expose them to financial contagion or which may make it more difficult for the banks to be wound down in an orderly fashion (avoiding damage to the wider provision of banking services) if they fail. The Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) are given a new objective in relation to the continuity of the provision in the United Kingdom of the core services related to core activities.

7. Secondly, the draft Bill amends the Insolvency Act 1986 and related Scottish and Northern Ireland legislation to provide that deposits which are eligible for protection under the financial services compensation scheme are to be preferential debts. This will ensure that such deposits rank ahead of other unsecured claims in insolvency.

[1] Independent Commission on Banking terms of reference (2010).

8. Thirdly, the draft Bill gives the Treasury power to make regulations governing the way in which the PRA may use its powers under the Financial Services and Markets Act 2000 (FSMA) to impose debt requirements on specified classes of institutions.

9. Finally, the draft Bill gives the Treasury power to require the PRA, the FCA and the Bank of England to impose fees on members of the financial services industry in order to cover relevant expenses incurred by the Treasury in connection with UK membership of, or Treasury participation in, specified international organisations, such as the Financial Stability Board.

10. The majority of the provisions of the draft Bill amend provisions of FSMA; many of the amendments are to provisions which are being inserted by the Financial Services Bill which is currently going through committee stage in the House of Lords (its second House). A consolidated version of FSMA, showing the effects of the amendments being made in the Financial Services Bill can be seen at http://www.hm-treasury.gov.uk/d/fin_fs_bill_consolidated_fsma.pdf.

TERRITORIAL EXTENT AND APPLICATION

11. The draft Bill extends to England and Wales, Scotland and Northern Ireland.

Northern Ireland

12. The draft Bill includes provisions amending the Insolvency (Northern Ireland) Order 1989 to introduce a new category of preferential debts. The provisional view of the Department for Enterprise, Trade and Investment of Northern Ireland is that these amendments are incidental to transferred matters, and that it is not therefore necessary to obtain a legislative consent motion.

COMMENTARY

13. In the commentary, references to "new sections" are to the new sections to be inserted into the Financial Services and Markets Act 2000 ("FSMA") by the draft Bill.

Ring-fencing

Clause 1: Objectives of the Financial Conduct Authority

14. *Clause 1* amends FSMA to give the FCA a new continuity objective. New section 1EA defines the "continuity objective": the protection of the continued provision in the UK of core services. This objective will be relevant when the FCA is exercising its general functions in relation to the ring-fencing matters listed in *subsection (2)*. *Subsection (3)* sets out the ways in which the FCA is to be required to advance the continuity objective. Equivalent provision is made in relation to the PRA, which is expected to be the main regulator in relation to ring-fencing. See further paragraph 17 below. The focus is on ensuring that there is no adverse effect on the continuity of the core services in the United Kingdom.

15. The relationship between the new continuity objective and the FCA's existing

objectives is determined in new section 1B(4) (inserted by clause 1(1)(b)), which limits the FCA's duty to promote effective competition where this is not compatible with advancing the continuity objective in relation to the matters specified in section 1EA(2).

Clause 2: Objectives of the Prudential Regulation Authority

16. *Clause 2* amends FSMA to give the PRA the same continuity objective as the FCA. That objective is set out in new section 2BA. When the PRA is acting in relation to matters related to ring-fencing (listed in *subsection (2)),* and only then, *subsection (1)* requires the PRA both to act at all times compatibly with its continuity objective, and to advance either its general objective or its continuity objective. Even where it is advancing its general objective, the PRA must act compatibly with the continuity objective.

17. *Subsection (4)* sets out the ways in which the PRA is primarily required to advance the continuity objective. The PRA must ensure that the way in which the business of a ring-fenced body is carried out does not harm the continued provision of core services in the United Kingdom; that the business of ring-fenced bodies is protected from risks which may arise elsewhere in the financial system (including risks arising outside the United Kingdom); and that, in the event that a ring-fenced body becomes insolvent or fails in any other way, its failure does not harm the continued provision of the core services in the United Kingdom. The PRA is not required to ensure that any particular ring-fenced body does not fail, provided that its failure can be so managed that the continued provision of core services elsewhere in the UK is not adversely affected.

18. *Clause 2(3)* amends new section 2C of FSMA to ensure that the PRA is required to act compatibly with its continuity objective when it is discharging its general objective in relation to insurance activities (or persons carrying on those activities).

19. *Clause 2(4)* amends new section 2D of FSMA to ensure that the PRA will be required to act compatibly with the continuity objective in when it is discharging its general functions in relation to any additional activities (or persons carrying on those activities).

20. *Clause 2(5)* inserts paragraph (aa) into section 2E of FSMA to define what is meant by a reference to the objectives of the PRA in connection with any function of the PRA relating to the ring-fencing matters listed in section 2BA(2).

Clause 3: Relationship between regulators

21. *Clause 3(1)* amends new section 3E of FSMA to insert a requirement (in new paragraph (za)) that the Memorandum of Understanding, which will be prepared and maintained by the regulators to describe their respective roles under FSMA, contains provision about the co-ordination by the regulators of the exercise of their respective general functions to advance their continuity objectives.

22. *Clause 3(2)* amends section 3I(4) of FSMA, to extend the PRA's power to give a direction to the FCA not to exercise its powers (or not to do so in a specified way) so that the PRA may give such a direction where it is of the opinion that the exercise of the FCA's power threatens the continuity of the core services in the United Kingdom.

Clause 4: Ring-fencing of certain activities

23. *Clause 4(1)* inserts new Part 9B (ring-fencing) into FSMA.

24. *New section 142A(1)* defines "ring-fenced body" for the purposes of FSMA, as any UK institution which has been given permission under FSMA to carry out a core activity. *Subsection (2)* excludes building societies from the definition of "ring-fenced bodies" and gives the Treasury power to exclude other institutions from the definition by order. This will enable the Treasury to provide for a *de minimis* threshold, so that only banks above a certain size are required to become "ring-fenced bodies". *Subsection (3)* sets out the condition which must be satisfied before the Treasury is able to make such an Order: they must be satisfied that excluding the institution in question from the definition of a ring-fenced body would not harm the continued provision in the United Kingdom of core services. *Subsection (4)* allows the Treasury to set conditions on the grant of an exemption from the definition of a "ring-fenced body", and *subsection (5)* defines "UK institution" for the purposes of the section.

25. *New section 142B* defines "core activity" for the purpose of FSMA. *Subsection (2)* provides the regulated activity of accepting deposits is to be a core activity, but also gives the Treasury power to provide for exceptions to this, by making an order setting out circumstances in which accepting deposits is not to be treated as a core activity. The Treasury may therefore provide that accepting deposits of high-net worth individuals, or large corporate entities, is not a core activity, so that such deposits may be held in banks which are neither ring-fenced nor exempt from the obligations to be ring-fenced banks under section 142A(2).

26. *Subsections (3) and (4)* set out the condition which must be satisfied before the Treasury are able to make such an order – they must be satisfied that it is not necessary for accepting deposits to be treated as a core activity either to protect the depositors specified in the order, or to protect the continued provision of the core services in the United Kingdom.

27. *Subsection (5)* gives the Treasury power to provide for additional core activities (and, when creating a new core activity, to provide for the circumstances in which the carrying on of the activity concerned is not to be considered to be a core activity).

28. *Subsection (6)* sets out the conditions which must be satisfied for the Treasury to create a new core activity. First, the Treasury must be satisfied that an interruption in the provision of the services concerned would harm UK financial stability (or the financial stability of a significant part of the UK financial system), and secondly, the Treasury must consider that making the activity in question a core activity is a more

effective way of protecting the continued provision of the services associated with that activity.

29. *New section 142C* defines "core services" for the purposes of FSMA. *Subsection (2)* defines the "core services" which are associated with the core activity of accepting deposits (the only core activity created on the face of the draft Bill), by identifying the categories of services which are to be "core services". It will not be necessary for ring-fenced bodies to provide every possible service which could be described as falling into these categories. Some banks only provide certain forms of payment from their accounts. Indeed, some banks may choose not to provide any overdraft facilities. S*ubsection (3)* gives the Treasury power to require that any service not included in the categories listed in *subsection (2)* which is provided in connection with the core activity of accepting deposits is also to be considered to be a core service. *Subsection (4)* requires that, when the Treasury creates a new core activity in the exercise of its power under section 142B(5), the Treasury must in the same order identify those services provided in the course of that activity which are to be core services.

30. The definition of core services is intended to be comprehensive, and those services which do not fall with the categories of services listed in *subsection (2)*, and are not specified as core services in an order made by the Treasury under *subsection (3)* or *(4)* will not be core services, however closely they are associated with a particular core activity.

31. *New section 142D* defines "excluded activity" for the purposes of the Act. *Subsection (2)* provides that the regulated activity of dealing in investments as principal is an excluded activity, but also gives the Treasury power to provide for exceptions to this, by making an order setting out the circumstances in which dealing in investments as principal is not to be considered to be an excluded activity.

32. *Subsection (3)* sets out the condition which must be satisfied before the Treasury may make such an order. The Treasury must be satisfied that allowing ring-fenced bodies to deal in investments on their own account in the specified circumstances will not cause significant harm to the continued provision of core services in the United Kingdom.

33. *Subsection (4)* gives the Treasury power to provide for additional excluded activities (and, when creating a new excluded activity, to provide for the circumstances in which the carrying on of the activity concerned is not to be considered to be an excluded activity). *Subsection (5)* clarifies that the activity concerned need not be regulated under FSMA. *Subsections (6) and (7)* set out the conditions which must be satisfied before the Treasury may provide for an additional excluded activity. Under *subsection (6),* the Treasury is required to consider the risks which would arise for the ring-fenced body in the event that it carried on the activity concerned, and whether permitting a ring-fenced body to carry on that activity would increase the risk that its failure would harm the continued provision of the core services in the UK. *Subsection*

(7) requires the Treasury to be of the opinion that it is necessary or expedient to make the order to protect the continued provision in the UK of the core services.

34. *New section 142E* gives the Treasury power to make an order imposing prohibitions on ring-fenced bodies. *Subsection (1)* specifies the prohibitions which may be imposed in such an order. *Subsection (2)* specifies the conditions which must be satisfied before the Treasury may make such an order. The Treasury must have regard to the risks to which a ring-fenced body would be exposed if it did anything the Treasury propose to prohibit in the order, and consider whether allowing a ring-fenced body to do the things prohibited in the order would increase the chance that the failure of the ring-fenced body would harm the continuous provision of the core services in the UK. Under *subsection (3),* the Treasury must also be of the opinion that it is necessary or expedient to make the order to protect the continued provision in the UK of the core services. Under *subsection (4)* an order made under this section may also contain exemptions from the proposed prohibitions, and make any such exemptions subject to conditions.

35. *New section 142F* makes additional provision as to what may be included in an order made by the Treasury under new sections 142A, 142B, 142D or 142E. In particular, the Treasury are given power to confer powers on themselves, or on either the FCA or the PRA in such an order. They may also authorise the regulator to make rules, and, under *subsection (2),* make the exercise of the regulator's new powers (including any rule-making power provided for) subject to conditions or requirements set out in the order.

36. *New section 142G(1)* provides for the consequences where a ring-fenced bodies carries on any excluded activity, or contravenes any prohibition imposed under new section 142E. Under *subsection (1)* a ring-fenced body which has done this is treated as having contravened a requirement imposed on that body by the regulator under FSMA. It will in consequence be liable to the disciplinary measures and penalties which the regulators may impose under Part 14 of FSMA. However, under *subsection (2),* the ring-fenced body will not have committed a criminal offence solely by reason of the contravention, and transactions entered into contrary to a prohibition remain valid. Further, no-one will be able to rely on the contravention to bring an action for breach of statutory duty against the ring-fenced body, unless the Treasury make express provision for this in the exercise of the power given in *subsection (3). Subsection (4)* defines "the appropriate regulator" for the purposes of the section.

37. *New section 142H* makes provision in relation to the rules which must be made by the FCA and the PRA in relation to ring-fencing. *Subsection (1)* sets out the principle on which those rules are to be based. The relevant regulator (which will be the PRA, as initially all ring-fenced bodies will be PRA-authorised) is required to make rules to ensure that the provision by the ring-fenced body of the core services is not harmed by the actions or omissions of another person – for example the acts and omissions of any other company in the same group as the ring-fenced body. The regulator must also ensure that the ring-fenced body may carry on its business independently of the

other members of the group. *Subsection (2)* provides that the regulator may make rules limiting what shares and voting power a ring-fenced body may hold in another company, and impose requirements as to the arrangements the ring-fenced body must make to obtain the services or facilities it needs to carry on the core activity. No such provision may however be included in rules made by the regulator if the Treasury has made provision in these areas in an order made under new section 142E. *Subsection (3)* lists the areas where the regulator must make rules in relation to a ring-fenced body which is a member of a group. These areas include both areas described in subsection (2), unless the Treasury has made provision in relation to them in an order under new section 142E. In addition, the regulator must make rules in relation to each of the areas specified in paragraphs (b) to (e), regulating the relations between the ring-fenced body and the rest of the group, requiring the provision to the regulator of information in relation to intra-group transactions and providing for the independent governance of the ring-fenced body. This does not limit the general rule making power of either regulator. *Subsections (4) and (5)* define "shares" and "voting power", and "the appropriate regulator", respectively, for the purpose of the section.

38. *New section 142I* requires the PRA (and where relevant the FCA) to carry out a review of their ring-fencing rules every five years, to report to the Treasury on that review, and publish the report. The Treasury must lay a copy of the report before Parliament.

39. *New section 142J* gives the Treasury power to make an order regulating the way in which the regulator may exercise its powers under FSMA to impose requirements on a relevant body as to the debt which must be issued or maintained by that body. *Subsection (2)* defines "relevant body" for the purpose of the section. Ring-fenced bodies will be relevant bodies, but the definition is not limited to ring-fenced bodies. A body corporate which has permission under FSMA to accept deposits, and a body corporate which is a member of the same group as a ring-fenced body or of another body corporate which has permission under FSMA to accept deposits which is not itself a ring-fenced body will also be "relevant bodies" for the purposes of this section. *Subsection (3)* defines "debt instrument" for the purposes of the section. The definition is a broad one: all forms of debt including bonds and any form of transferable debt would be covered. *Subsection (4)* makes additional provision as to what may be included in an order made by the Treasury under this section. The Treasury may both require the regulator to impose specified debt requirements on a relevant body, and limit the requirements which may be imposed. They may require the regulator to consult the Treasury before imposing a requirement, and give themselves power to issue directions to the regulator about any matter specified in the order.

40. *New section 142K(1)* gives the Treasury power to amend any provision of primary or secondary legislation which imposes liability on members of a corporate group in consequence of any act or omission of any other member of that group. Under *subsection (2),* that power may only be exercised where the Treasury consider that the amendments in question are necessary or expedient in order to ensure that the ability

of the ring-fenced body to carry on the core activity is not harmed by any act or omission of any other member of its group.

41. *New section 142L* explains how the regulated activities of accepting deposits and dealing in investments as principal are to be understood for the purpose of Part 9B of FSMA.

42. *Clause 4(2)* of the draft Bill inserts definitions of "core activities", "core services", "excluded activities" and "ring-fenced body" into section 417 of FSMA.

Clause 5: Banking business transfer schemes

43. *Clause 5* amends section 106 of FSMA. Section 106 provides for banking business transfers – which enable parties to transfers of a banking business to apply to the court for an order sanctioning the transfer. The amendments made in clause 5 provide for a new category of "banking business transfer scheme", to allow an authorised person with permission to accept deposits to use the procedure in Part 7 of FSMA to make transfers of part of their business to comply with the ring-fencing requirements.

44. A transfer of part of a banking business will qualify as a banking business transfer scheme under Part 7 of FSMA if it satisfies the conditions laid down in subsection (2A). It must be a transfer by an authorised person with permission to carry on a core activity of part or all of the business carried on by that person to another entity; the transfer must be made to avoid committing a "ring-fencing contravention", and the transfer concerned must not be made by a building society or credit union, or fall within the scope of Part 27 of the Companies Act 2006 on mergers and divisions of public companies. "Ring-fencing contravention" is defined in new subsection (4A), inserted by *subsection (4).* It will include contraventions of the prohibition on ring-fenced banks carrying on excluded activities in new section 142G; and contraventions of ring-fencing rules made by the regulator in accordance with new section 142H. *Subsection (5)* inserts new subsection (2A) into section 107 of FSMA, modifying the procedure applying to applications for court approval of banking business transfers made under section 106(2A), so that no application may be made without the approval of the PRA.

Clause 6: Building societies: power to make provision about ring-fencing

45. *Clause 6* enables the Treasury to apply ring-fencing to building societies. Building societies are excluded from the definition of a ring-fenced body under section 142A because they are already subject to significant restrictions under the Building Societies Act 1986. The powers in this clause will enable the regime for building societies to be aligned with the ring-fencing regime. *Clause 6(1)* gives the Treasury power to make regulations making provision for ring-fencing in relation to building societies, for the same purposes as the provisions in new Part 9B of FSMA, or in any secondary legislation made under powers given in that Part. The Treasury may also provide that the continuity objective is to apply to any function given to the FCA or the PRA in such regulations, or as a result of such regulations. *Subsection (2)* lists a number of things which may be done by the Treasury in regulations made under this

power, including the amendment of the Building Societies Act 1986. *Subsections (3) and (4)* provide that any regulations made under the power given in clause 6 will be made by statutory instrument and subject to the affirmative resolution procedure. *Subsection (5)* defines the terms "building society", "the relevant continuity objective", "core activity" and "ring-fenced body" for the purposes of the section.

Depositor Preference

Clause 7: Preferential debts: Great Britain

46. *Clause 7* makes amendments to the Insolvency Act 1986 and the Bankruptcy (Scotland) Act 1985 to ensure that the specified class of deposits are treated as preferential debts on insolvency in Great Britain. *Subsection (1)* amends Schedule 6 to the Insolvency Act 1986, to insert new paragraphs 15B and 15C into the schedule. *Paragraph 15B* defines the new category of preferential debts. Where a deposit is within the scope of the financial services compensation scheme ("FSCS"), it will be a preferential debt. Where a deposit is not eligible for protection under the FSCS, it will not be a preferential debt. If a single depositor has a very large deposit, part of which is not eligible for protection under the FSCS, only the part of that deposit which is covered by the FSCS will be a preferential debt. The remainder of the deposit will not be a preferential debt: it will rank equally to other non-preferred unsecured debts. *Paragraph 15C* defines the terms "eligible deposit" and "deposit" for the purposes of the new category of preferential debts. Deposits which were held in dormant accounts and have been transferred to authorised reclaim funds under the Dormant Bank and Building Society Accounts Act 2008 are included in the definition of "deposit".

47. *Subsection (2)* amends section 386 of the Insolvency Act 1986 to add a reference to deposits covered by the financial services compensation scheme to the list of preferential debts.

48. *Subsection (3)* amends Part 1 of Schedule 3 to the Bankruptcy (Scotland) Act 1985 to insert new paragraph 6B. The Insolvency Act 1986 covers insolvency in both England and Wales and Scotland, but only deals with bankruptcy in England and Wales. Bankruptcy in Scotland is dealt with under the Bankruptcy (Scotland) Act 1985. This paragraph makes equivalent provision in relation to bankruptcy and sequestration proceedings in Scotland to the provision made in new paragraphs 15B of Schedule 6 to the Insolvency Act 1986 which will apply to England and Wales and other insolvency proceedings in Scotland. *Subsection (4)* amends Part 2 of Schedule 3 to the 1985 Act to insert new paragraph 9A. This paragraph contains equivalent definitions of "eligible deposit" and "deposit" to those set out in new paragraph 15C of Schedule 6 to the Insolvency Act 1986, save that a balance transferred to an authorised reclaim fund is not included in the definition of a "deposit" for the purpose of the 1985 Act, though it is included in the definition of "deposit" in the Insolvency Act 1986. The insolvency of a reclaim fund in Scotland would be subject to the Insolvency Act 1986, and not the 1985 Act, and it is therefore not necessary to make rights to balances transferred to reclaim funds preferential debts under the 1985 Act.

Clause 8: Preferential debts: Northern Ireland

49. *Clause 8* amends the Insolvency (Northern Ireland) Order 1989 (S.I. 19089/2405 (N.I.19)) to make equivalent provision in relation to Northern Ireland.

Fees to meet Treasury expenditure

Clause 9: Fees to meet Treasury expenditure

50. *Clause 9* inserts new sections 410A and 410B into FSMA.

51. *New section 410A(1)* gives the Treasury power to make regulations to give themselves a power to direct a regulator (the Financial Conduct Authority, the Prudential Regulation Authority or the Bank of England) to impose fees on certain persons to meet relevant expenses, to make related provision as to the way in which the regulator must comply with any direction given by the Treasury under the regulations, and to require the regulator to pay any monies received through the levy to the Treasury. The PRA may be required to impose fees on PRA authorised persons. The FCA may be required to impose fees on other authorised persons or recognised investment exchanges. The Bank of England may be required to impose fees on recognised clearing houses provided they are not regulated by the PRA or the FCA. The definition of "relevant persons" (in *subsection (8))* has been designed to ensure that no person can be made liable to pay fees to more than one regulator.

52. *Subsection (2)* defines "relevant expenses" as those expenses incurred by the Treasury in connection with, or for the purposes of, United Kingdom membership of (or Treasury participation in) international organisations identified in the regulations, provided that the Treasury considers that the expenses are connected to the organisation's work in relation to financial stability or financial services. "Relevant expenses" includes expenses of a capital nature (for example, the provision of an endowment). Other examples of expenses which may be relevant for this purpose are the payment of a membership fee or the secondment of staff to a relevant international organisation.

53. *Subsection (3)* ensures that the PRA and the FCA charge fees in pursuance of a direction by way of rules.

54. *Subsection (4)* applies Chapter 2 of Part 9A of FSMA to rules made by either the PRA or the FCA charging fees in order to comply with a direction from the Treasury under regulations made under section 410A, as it applies to any rules made by the regulators charging fees, so that all rules charging fees are subject to the same procedural requirements.

55. *Subsection (5)* applies paragraph 32 of Schedule 17A to FSMA to fees charged by the Bank of England in compliance with a direction from the Treasury under regulations made under section 410A so that such fees are subject to the same provisions as other fees the Bank charges to recognised clearing houses.

56. *Subsection (6)* makes further provision as to what may be included in regulations

made by the Treasury. In particular, the Treasury may make provision about what is, or what is not, to be regarded as an expense for this purpose.

57. *Subsection (7)* ensures that each regulator is able to recover any amount payable to it for fees imposed in consequence of regulations made by the Treasury as a debt owed to it.

58. *Subsection (8)* defines "relevant persons" for the purposes of the section.

59. *New section 410B* sets out the requirements which the Treasury must satisfy in giving any direction to the regulators as a result of regulations made under new section 410A. Under *subsection (2),* the Treasury must first consult the regulator on whom they propose to impose a direction. *Subsection (3)* provides that the direction must be in writing and sets out what information it should contain. *Subsection (4)* requires the Treasury to lay a copy of any direction it gives to the regulator under regulations made under section 410A before Parliament.

Clause 10: Amendments of section 429 of FSMA 2000

60. *Clause 10* amends section 429 of FSMA 2000 to provide for the parliamentary procedure applicable to statutory instruments made under new sections 142A(2)(b) 142K and 410A. Orders made under section 142K of FSMA will be subject to affirmative resolution procedure, as will regulations made under section 410A (apart from regulations which only contain provision made under section 410A(2) (prescription of international organisations), which will be subject to negative resolution procedure). The first order made under section 142A(2) (which excludes specified institutions from the definition of ring-fenced bank) and any subsequent orders made under that power which restrict or remove an exemption, are to be made by affirmative resolution procedure.

Clause 11: Interpretation

61. *Clause 11* defines "the FCA", "FSMA 2000" and "the PRA".

Clause 12: Transitional provisions and savings

62. *Clause 12* allows the Treasury to make transitional and saving provisions which may be necessary on the commencement of any provision in the draft Bill, and gives the Treasury power to confer functions on the FCA or the PRA for this purpose, and to modify, exclude or apply enactments should this be needed to enable the commencement of any provision in the draft Bill.

Clause 13: Extent, commencement and short title

63. *Clause 13* provides that the draft Bill extends to the whole of the United Kingdom (*subsection (1)),* that clauses 11 to 13 come into force on the day the Act receives royal assent *(subsection (2))*, that all other provisions will come into force on days appointed by the Treasury by order (*subsections (3) and (4)),* and that the short title of the draft Bill when it has been enacted, will be the Financial Services (Banking

Reform) Act 2013 *(subsection (5))*.

FINANCIAL EFFECTS

64. There will be no significant effects on spending by Government departments met from money voted by Parliament. The effects on expenses incurred by the Bank of England and the Financial Conduct Authority and the Prudential Regulator are considered in the impact assessment.

PUBLIC SECTOR MANPOWER

65. The draft Bill will have no impact on manpower in government departments.

SUMMARY OF THE IMPACT ASSESSMENT

66. The purpose of this draft Bill is to implement the recommendations of the Independent Commission on Banking with regard to ring-fencing and depositor preference. The impact assessment considers 2 options:

a. Do nothing. This would leave the structure of UK banks unreformed and thus not address the flaws in unstructured universal banking exposed by the recent financial crisis;

b. Implement ring-fencing and depositor preference. This is the preferred option. This option would require UK banks to ring-fence ‘core activities’ from ‘excluded activities’, conducting them in separate legal entities. FSCS-insured deposits would become preferential debts within the creditor hierarchy.

67. The preferred option is the most cost-effective way of meeting the Government’s objectives. Ring-fencing and depositor preference are expected to impose transitional and ongoing costs on UK banks: the Government estimates the ongoing costs in the range £2bn to £5bn per annum, with one-off transitional cost in the range £1.5bn to £2.5bn. Additional private costs for UK banks are likely to create a cost to GDP: the Government estimates this will lead to a reduction in the long-run level of GDP of between 0.04 and 0.1 per cent, equivalent to an average annual cost to GDP of £0.4bn to £1.1bn. There is also likely to be a consequent cost to the Exchequer in reduced tax receipts, estimated at between £150mn and £400mn per annum, and in a reduction in the value of the Government’s shareholdings in Royal Bank of Scotland and Lloyds Banking Group, estimated in the range £2bn to £5bn relative to a ‘do nothing’ baseline. There is also expected be a cost to the regulator (PRA) of enforcing the new regulations, estimated at around £2mn per annum. The benefits of the preferred option will accrue from increased financial stability. These cannot be quantified precisely (only illustrative estimates are included in the impact assessment) but are expected significantly to exceed the costs of the preferred option.

COMPATIBILITY WITH THE EUROPEAN CONVENTION ON HUMAN RIGHTS

68. The Government confirms that it is of the opinion that the Bill is compatible with the Convention rights. A number of provisions engage Article 1, Protocol 1 (A1P1) to the Convention. A1P1 specifies that "every natural and legal person is entitled to the peaceful enjoyment of his possessions" and "no-one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law". New section 142G, which bars ring-fenced bodies from carrying on excluded activities (defined in new section 142D), and contravening prohibitions set by the Treasury under new section 142E, considered together with the power given to the Treasury to provide for new excluded activities and prohibitions (new sections 142D and 142E) will restrict the way in which ring-fenced bodies may use their possessions, by limiting the activities in which they can engage. The requirement for the regulator to make rules limiting the ability of ring-fenced bodies to invest in other companies and regulating the transactions which they can enter into with other members of the same corporate group under new section 142H similarly limit the way in which the ring-fenced body may use its own assets.

69. The powers given to the Treasury to regulate the debt requirements which may be imposed on ring-fenced bodies under new section 142J are also capable of being exercised in a way which would control a ring-fenced body's use of its possessions, by imposing a level of debt requirement which, in practice, may prevent a ring-fenced body from redeeming debt, or requiring it to issue additional debt. (The exercise of this power may also give rise to issues under Article 14 of the Convention, which prohibits discrimination in relation to the rights and freedoms set out in the Convention, if it imposes different restrictions on different firms without an objective justification for those differences).

70. The Treasury believes that the restrictions on the way in which ring-fenced bodies may conduct their business are being imposed for a legitimate purpose – to protect the continuity of retail banking in the UK (so protecting both consumers and financial stability in the UK). The Treasury also considers that the provisions on excluded activities in the draft Bill strike a fair balance between the interests of the ring-fenced bodies which will be subject to restrictions, and the interests of the community in the continuation of a safe retail banking system, and the powers given to the Treasury and to the PRA and the FCA to impose further restrictions are capable of being exercised to achieve such a fair balance. The Treasury and the regulators are both, as public authorities, subject to the duty to act compatibly with the Convention rights under section 6 of the Human Rights Act 1998, and must therefore ensure that such a balance is achieved, and that any difference in treatment of those subject to the restrictions is objectively justified.

71. The powers given to the Treasury to require the regulators and the Bank of England to

impose fees on certain classes of authorised person to contribute towards Treasury expenses in relation to international organisations such as the Financial Stability Board is also likely to result in an interference with rights under A1P1. This power in practice permits the Treasury to impose a tax (the fees) on those working in the field of financial services. The European Court on Human Rights has recognised that states have a wide margin in framing and implementing policy on taxation. The fees will be imposed for the legitimate aim of reducing the level of public expenditure, and the Treasury will be obliged under section 6 of the Human Rights Act 1998 to ensure that the conditions set for the imposition of the fees strike a fair balance between the rights of those required to pay the fees and the public interest.

COMMENCEMENT

72. The only provisions of the draft Bill that are to come into force on the day on which the Bill receives Royal Assent are those dealing with interpretation, extent, commencement and the short title to the Bill. All the other provisions of the Bill will come into force on the day or days appointed by the Treasury by order.

A Summary of responses

A.1 HM Treasury received over 80 separate submissions in response to the Banking Reform White Paper consultation, which closed on 6 September 2012. Views and evidence was provided from a wide range of respondents including financial sector companies, industry groups, consumer groups, pension trustees, academics, professional services firms, law firms, charities, think tanks, and members of the public. This annex provides a high-level summary of responses. Further discussion of respondents' views can be found in Chapter 2 (Policy Overview). HM Treasury extends its thanks to all those who made contributions.

Ring-fencing

A.2 There was a considerable range of opinion on the ring-fence proposals. Some respondents felt the ring-fence proposals were too prohibitive, and may put UK headquartered banks at a competitive disadvantage in a global market place. Respondents further argued that a restrictive ring-fence would prevent them offering a full package of services to businesses, particularly those requiring more complex financial products and services.

A.3 Others, including many of the responses from members of the public, charities and consumer groups, felt that the ring-fence proposals did not go far enough; and some felt full separation between retail banks and investment banks was needed to ensure that riskier investment banking activities do not compromise the survival or stability of retail banks. Some respondents felt that tighter regulatory control on financial products and services allowed in a ring-fenced bank was required.

A.4 Respondents also gave views on issues such as the level of the SME threshold and the level of the de minimis threshold for exempting small banks from ring-fencing. There was broad consensus on a need for de minimis to avoid requiring smaller institutions that do not pose a threat to financial stability to ring-fence. Many supported the threshold at £25billion of mandated deposits, but some respondents felt it was too high and should be set lower. Similarly, there was broad support for an SME threshold based on company turnover, in line with the Companies Act (2006). While views varied on the level of the threshold, on balance respondents preferred £6.5m annual turnover rather than £25.9m turnover. A range of views were also expressed on other technical matters including pension arrangements, geographical restrictions and the threshold for high net-worth individuals. Views are discussed further in Chapter 2. HM Treasury will consult on all secondary legislation.

Loss absorbency

A.5 On primary loss-absorbing capacity (PLAC) and bail-in, there was broad consensus that the UK's approach should be consistent with progress at the European level. There were differing views about whether some types of liabilities should be excluded from the bail-in tool, with some respondents viewing a broad tool as least distortive, while others thought a narrow scope would make bail-in more effective. Respondents thought it was important to be clear on when the bail-in tool would be used, and the safeguards which would apply to creditors.

A.6 There was relatively broad support for depositor preference, although some respondents felt that other groups of creditors should also be preferred alongside FSCS insured deposits. In particular, respondents from charities argued that their deposits should be made preferred debts.

A.7 Some respondents felt that banks' own pension schemes should also be preferred alongside FSCS insured deposits. They argued that pension trustees would have a limited ability to influence a bank's behaviour or appetite for risk and that the lack of preference would weaken the covenant between the pension schemes and the sponsoring bank. This could lead to more conservative funding and investment strategies, and may require deficits to be paid quicker. Other respondents felt that bank pension schemes should not be preferred as it would create creates inconsistencies in pension protection for employees in other sectors.

Competition

A.8 As the White Paper did not ask any specific questions on competition, views on competition were limited. However, some respondents expressed their support for greater competition in the UK banking sector. Respondents suggested this could be achieved by more regional and mutually-owned banks, which they thought would be better placed to cater for customer needs and rebalance regional inequalities. There was also support for reducing barriers to entry and exit to create a more diverse banking sector, and a more level playing field for smaller players.

B Impact assessment

B.1 This section contains the impact assessment.

Title: Financial Services (Banking Reform) Bill **IA No:** **Lead department or agency:** HM Treasury **Other departments or agencies:** Department for Business, Innovation and Skills	**Impact Assessment (IA)** **Date:** 12/10/2012 **Stage:** Consultation **Source of intervention:** Domestic **Type of measure:** Primary legislation **Contact for enquiries:** Banking.commission@hmtreasury.gsi.gov.uk

Summary: Intervention and Options

RPC Opinion: RPC Opinion Status

Cost of Preferred (or more likely) Option				
Total Net Present Value	**Business Net Present Value**	**Net cost to business per year** (EANCB on 2009 prices)	**In scope of One-In, One-Out?**	**Measure qualifies as**
£117,600m	£m	£m	No	NA

What is the problem under consideration? Why is government intervention necessary?

Structural reform of UK banks is required to tackle the 'too big to fail' problem: banks that are large, systemic and too complex for their failure to be safely managed without serious economic consequences or recourse to public funds are perceived to benefit from an implicit government guarantee. This represents an anti-competitive subsidy to large banks, creates moral hazard and places a contingent liability on the taxpayer. The UK Government, along with G20 partners, has committed to removing any implicit guarantees to the banking system.

What are the policy objectives and the intended effects?

The policy objective is to curtail the perceived implicit government guarantee enjoyed by banks seen as 'too big to fail' and make UK banks more resilient to shocks and more resolvable in the event of failure by:
- requiring the ring-fencing of retail deposit-taking from wholesale/investment banking, to insulate essential retail banking services from shocks originating elsewhere in the financial system, and to ensure that the continuity of these services can be maintained in the event of bank failure; and
- preferring retail deposits in insolvency and setting a framework for the imposition of debt requirements by regulators, to ensure that in the event of failure losses fall on bank creditors not depositors or taxpayers.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

The draft Banking Reform Bill is the latest step in a process of policy development that began with the establishment of the Independent Commission on Banking (ICB) in June 2010. The ICB examined a range of alternative structural and non-structural reform options to tackle the 'too big to fail' problem, including full separation of retail from investment banking and narrow banking. In its final report in September 2011, the ICB rejected these alternatives in favour of ring-fencing, depositor preference and other loss-absorbency reforms. The Government accepted the ICB's recommendations and has explored different options for the precise calibration of ring-fencing and depositor preference, and published a White Paper consulting on these alternatives in June 2012. Following this process, the Government has now formed its lead option, to proceed with the measures in the draft Banking Reform Bill. The Government believes that this option represents the best balance between benefits to financial stability and costs to UK banks and the economy.

Will the policy be reviewed? It will not be reviewed. **If applicable, set review date:** Month/Year

Does implementation go beyond minimum EU requirements?			Yes		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	**Micro** No	**< 20** No	**Small** No	**Medium** Yes	**Large** Yes
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:**	**Non-traded:**	

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister: Greg Clark Date: 10 October 2012

Summary: Analysis & Evidence

Policy Option 1

Description: The Government does not implement any of the measures in the Financial Services (Banking Reform) Bill. This is the baseline used for measuring the impact of Policy Option 2.

FULL ECONOMIC ASSESSMENT

Price Base Year	PV Base Year	Time Period Years 30	Net Benefit (Present Value (PV)) (£m)		
			Low: 0	**High:** 0	**Best Estimate:** 0

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	0		0	**0**
High	0		0	**0**
Best Estimate	0		0	**0**

Description and scale of key monetised costs by 'main affected groups'

Zero as the Government not implementing the measures in the Banking Reform Bill will impose no additional costs incremental to regulations currently in train.

Other key non-monetised costs by 'main affected groups'

Zero for the reason given above.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0		0	**0**
High	0		0	**0**
Best Estimate	0		0	**0**

Description and scale of key monetised benefits by 'main affected groups'

Zero as the Government not implementing the measures in the Banking Reform Bill will produce no additional benefits incremental to regulations currently in train.

Other key non-monetised benefits by 'main affected groups'

Zero, for the reasons given above.

Key assumptions/sensitivities/risks | **Discount rate (%)** |

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: N/A	**Benefits:** N/A	**Net:** N/A	No	NA

Summary: Analysis & Evidence

Policy Option 2

Description: Proceed with measures in the draft Financial Services (Banking Reform) Bill.

FULL ECONOMIC ASSESSMENT

Price Base Year 2010	PV Base Year 2019	Time Period Years 30	Net Benefit (Present Value (PV)) (£m)		
			Low: SEE TEXT	**High:** SEE TEXT	**Best Estimate:** 117,600

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low	1,500		400	**7,600**
High	2,500		1,120	**20,900**
Best Estimate	2,000		720	**13,700**

Description and scale of key monetised costs by 'main affected groups'

Direct private costs to UK banks: £2bn - £5bn p.a. Direct costs to regulator: £20m (up-front), £2m p.a.
Indirect cost to GDP from banks passing increased private costs to economy: reduction in long-run GDP level of 0.04%-0.1% (equivalent to average annual GDP cost of £0.4bn - £1.1bn p.a.)
Indirect Exchequer impact: reduction in tax receipts of £150m-£400m p.a. and reduction of value of HMG shareholdings in RBS and Lloyds Banking Group of £2bn - £5bn, relative to 'do nothing' baseline.

Other key non-monetised costs by 'main affected groups'

Indirect cost to bank customers through changes in lending and saving rates.

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	SEE TEXT		SEE TEXT	**SEE TEXT**
High	SEE TEXT	N/A	SEE TEXT	**SEE TEXT**
Best Estimate	SEE TEXT		6,900	**131,300**

Description and scale of key monetised benefits by 'main affected groups'

Greater financial stability leading to fewer and less severe financial crises in the future, leading to higher levels of GDP in the future. This is a benefit to the UK economy as a whole.
Illustrative calculation shows that reducing probability of future crises by 10% and severity of future crises by 15% would produce an annual benefit equivalent to 0.47% of GDP (£6.9bn in 2010-11 terms).

Other key non-monetised benefits by 'main affected groups'

Reduced Government, and therefore taxpayer, support in a crisis as they become less frequent and severe.
Resolution authorities will be better able to resolve banks and at a lower cost.
There will be welfare benefits independent of GDP level, from greater financial and economic stability due to a reduction in the probability and severity of financial crises for the UK economy.

Key assumptions/sensitivities/risks | **Discount rate (%)** | 3.5

The reduction in the future probability and severity of financial crises that the policy will bring.
The extent to which banks pass through the cost of the policy to consumers, and the subsequent impact on GDP.

BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:			**In scope of OIOO?**	**Measure qualifies as**
Costs: N/A	**Benefits:** N/A	**Net:** N/A	No	NA

Evidence Base

Introduction

1. The financial crisis of 2007-09 revealed the urgent need to reform the UK banking system to improve the resilience of both individual banks and the system as a whole. In response to the crisis, as well as embarking on the radical reform of the UK regulatory architecture that is being taken forward in the Financial Services Bill currently before Parliament, the Government has committed to implementing structural reforms to UK banks, following the recommendations of the Independent Commission on Banking (ICB), chaired by Sir John Vickers.
2. As the ICB argued, banks that are large, systemic and too complex to be resolved in the event of failure benefit from a perceived implicit government guarantee, as market participants presume that, faced with the failure of such a bank, the Government would have no choice but to rescue it, if necessary using public funds. As well as creating moral hazard, this perceived guarantee represents an anti-competitive subsidy to large, complex banks and a contingent liability on the taxpayer. Along with other G20 members, the Government has committed to curtailing perceived implicit guarantees to the UK banking sector. The draft Financial Services (Banking Reform) Bill ('draft Bill') contains key measures to give effect to that commitment.
3. The draft Bill will implement the ring-fencing of retail and SME deposits from wholesale and investment banking recommended by the ICB. Ring-fencing, and the requirement that ring-fenced banks be separately capitalised and economically independent of their wider corporate groups, will insulate retail banking services from shocks originating elsewhere in the global financial system and will make both individual banks and the UK banking system as a whole more resilient. By requiring that retail banking services whose continuous provision is essential to households and SMEs are placed in separate legal entities, ring-fencing will help ensure that the continuity of those services can be maintained in the event that a ring-fenced bank, or its wider group, fails and needs to be resolved by the authorities.
4. The draft Bill will also make deposits eligible for protection under the Financial Services Compensation Scheme (FSCS) preferred debts in insolvency: preferring FSCS-protected deposits will help the authorities to ensure that in the event of bank failure, banks' wholesale creditors (investors who should be better placed to exert market discipline on banks to prevent them taking excessive risks) will be exposed to losses ahead of retail depositors and the FSCS that protects them. Some elements of the ICB's recommendations are not included in the draft Bill, for example the introduction of a bail-in tool, which the Government expects to deliver through transposition of forthcoming European legislation. These measures are therefore outside the scope of this Impact Assessment (IA).
5. The measures in the draft Bill will serve to curtail the perceived implicit government guarantee to banks seen as 'too big to fail'. The draft Bill is the latest stage of a process of policy development to meet this objective that began with the establishment of the ICB in the summer of 2010. Over the course of its deliberations, the ICB considered, and rejected, a range of alternative policy options, including full separation of retail and investment banking, full reserve banking and narrow banking, before forming its recommendations on ring-fencing and depositor preference. The Government has accepted those recommendations, and since the ICB's final report in September 2011 has explored a range of possible calibrations for ring-fencing and depositor preference. Having examined these alternatives, the Government has now developed its lead option, which will be implemented via the draft Bill. This IA sets out the estimated economic impact of the measures in the draft Bill.

Scope of this IA

Measures included in this IA

6. This IA covers the Government's implementation of the following ICB recommendations, which will be delivered through the draft Bill:

   - Ring-fencing of banking services whose continuity is essential to retail and SME customers from other functions of banks, to insulate them against shocks originating elsewhere in the global financial system, and to make it easier to preserve the continuity of those services, while managing the failure of financial institutions in an orderly manner and without injecting taxpayer funds.
   - Preferring deposits eligible for protection under the FSCS ('depositor preference') to increase the amount which the FSCS is able to recover in the event of a bank failure, as depositors' claims are assigned to the FSCS.
   - Setting the framework for the imposition of debt requirements by the regulator on banks, to ensure banks maintain sufficient loss-absorbing capacity.

Measures not included in this IA

7. The draft Bill will implement key elements of the ICB's recommendations, as set out above. However, some of the ICB's recommendations have been accepted by the Government but are being implemented by other means (other domestic legislation or EU legislation), and so are not included in the draft Bill. As they do not feature in the draft Bill, the impact of these measures is not included in this IA:

   - Requiring banks to divide their pension schemes in order to comply with ring-fencing: the Government continues to work with banks and pension scheme trustees on the most appropriate way to achieve the ICB's objective of ensuring that joint and several liabilities for pension scheme deficits do not create channels of contagion between ring-fenced and non-ring-fenced banks.
   - A bail-in tool: the Banking Reform White Paper built on the ICB's recommendations, setting out in more detail the key principles behind a credible and effective bail-in tool. The task of resolving large cross-border banks is complex and to ensure that UK banks are not disadvantaged relative to international competitors, it is important that the UK continues to work with other countries to design a broadly consistent bail-in tool which can work across different jurisdictions, particularly the EU, US and in Asia. G20 countries have already demonstrated a commitment to a bail-in tool, and the Government welcomes the inclusion of the tool within the European Recovery and Resolution Directive (RRD). The Government therefore expects the UK to implement bail-in through the transposition of this Directive and will work closely with its European partners to ensure a credible tool is delivered.
   - ICB competition recommendations: the ICB made various recommendations to increase competition in the banking sector. The recommendations have been accepted by the Government, but are not included in the draft Bill (and so are not covered in this IA) as they are either already implemented (Financial Conduct Authority competition objective); industry-led (Lloyds Banking Group 'Verde' divestment; account switching service); or will not result in immediate regulatory changes (possible future market investigation by competition authorities).

8. As a result of the exclusion of these measures from this IA, the figures given here for the total impact of the measures in the draft Bill will not be the same as those for the total cost of the entire ICB package given in the Banking Reform White Paper IA. This is because the White Paper IA included the impact of measures that are not covered by this IA.[1]

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[1] The White Paper IA estimated the total private cost to UK banks of the whole ICB package as falling in the range £4bn-£7bn per year and the GDP cost in the range £0.6bn-£1.4bn per year. The electronic version of the Banking Reform White Paper and accompanying IA can be found at http://www.hm-treasury.gov.uk/fin_stability_regreform_icb.htm.

Financial Services and Markets Act (2000) Fees

9. The draft Bill also includes provision to amend the Financial Services and Markets Act (2000) to enable HM Treasury to direct the regulators to impose fees on the industry to pay for the costs of the Government's participation in international financial stability fora. This measure is not part of the ICB's recommendations. As the proposed fees fall within the classification of a tax, this provision is outside the scope of this IA.

Description of options considered

Option 1: Baseline ('Do nothing')

10. Under this option, none of the measures in the draft Bill are implemented. However, independently of the draft Bill, substantial regulatory changes are under way and will be in place by the time the measures in the draft Bill would come into effect. These wider reforms are therefore assumed to take place under this 'do nothing' option, including:

   - Implementation of the Basel III Accord (through the EU Capital Requirements Directive (CRD) IV/ Capital Requirements Regulation (CRR)), including higher capital requirements for banks and tighter definitions of capital;
   - Introduction of a Globally Systemically Important Banks (G-SIB) capital surcharge to impose additional capital requirements on the largest and most systemically important banks;
   - Liquidity requirements imposed by the Financial Services Authority (FSA); and
   - Reform of the UK regulatory architecture through the Financial Services Bill. [2]

11. With these wider reforms being implemented independently of the draft Banking Reform Bill, this option serves as a baseline for assessing the impact of the measures in the draft Bill. The impact of the draft Bill measures will be considered incrementally to this baseline. Doing nothing beyond implementing the measures in the baseline will have zero incremental economic impact.

Option 2: Implement the measures in the draft Banking Reform Bill

12. The Government's lead option is to proceed with the measures in the draft Banking Reform Bill. These are:

   - **Ring-fencing** of banking services whose continuity is essential to retail and SME customers from other functions of banks, to insulate them against shocks originating elsewhere in the global financial system, and to make it easier to preserve the continuity of those services, while managing the failure of financial institutions in an orderly manner and without injecting taxpayer funds.
   - **Preferring deposits** eligible for protection under the FSCS **('depositor preference')** to increase the amount which the FSCS is able to recover in the event of a bank failure.
   - Setting the **framework for the imposition of debt requirements** by the regulator on banks, to ensure banks maintain sufficient loss-absorbing capacity.

Enabling nature of the draft Banking Reform Bill

13. The draft Bill will, for the most part, be enabling in nature: it will give powers and/or duties to HM Treasury and the regulatory authorities to impose requirements on UK banks. The precise nature of those requirements will be determined by a combination of secondary legislation and rules made by the regulators. These will define the details of, for example, what activities may not be conducted within the

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[2] More details on these regulatory reforms can be found at the following links:
Basel III Capital Requirements, Globally Systemically Important Banks (G-SIB) Surcharge and Counter-Cyclical Buffer - http://www.bis.org/publ/bcbs189.pdf and http://www.bis.org/publ/bcbs207.pdf
FSA Liquidity Regulations - http://www.fsa.gov.uk/pages/library/policy/policy/2009/09_16.shtml
FPC Macroprudential Powers – http://www.bankofengland.co.uk/financialstability/Pages/fpc/default.aspx
The Financial Services Bill – http://www.hm-treasury.gov.uk/fin_financial_services_bill.htm

ring-fence, and the financial relationships between ring-fenced and non-ring-fenced banks. The exact impact of the Banking Reform Bill will therefore depend on how these powers and duties are discharged.

14. For the purposes of this IA, assumptions have been made about the precise requirements that will be imposed by secondary legislation and/or regulatory rules. These are detailed in Annex A below. It has generally been assumed that secondary legislation and rules made under the powers conferred by the draft Bill will be in line with the policy set out in the June Banking Reform White Paper and in the Policy Document published alongside the draft Bill.[3]

15. When, following the passage of the Banking Reform Bill, secondary legislation is made it will be accompanied by further IAs covering the contents of that secondary legislation. The regulators are also required to publish rules in draft, with a cost-benefit analysis.

Costs and benefits

Summary of the costs and benefits of each policy option.

Option 1: Do nothing (Baseline)
The baseline policy option has **zero** costs and benefits.
Option 2: Implement measures in draft Banking Reform Bill
Monetised costs (gross): Annual total private cost to UK banks: £2bn – £5bn; Reduction in long-run GDP level: 0.04% - 0.1%; (equivalent to average annual GDP cost of £0.4bn - £1.1bn); **Present Value GDP cost**: £7bn – £20bn; Reduction in annual tax receipts: £150m – £400m; Reduction in value Government shareholdings in Royal Bank of Scotland (RBS) and Lloyds Banking Group: £2bn-£5bn. Monetised benefits (gross): Illustrative increase in long-run GDP level from greater financial stability: 0.47%; (equivalent to annual GDP increase of £6.9bn in 2010-11 terms); **Illustrative Present Value GDP benefit**: £131.3bn. Non-monetised benefits: Improved resilience and resolvability of UK banks will, by curtailing perceived implicit government guarantees, and reduce moral hazard and thus incentives for banks to take excessive risks. Greater financial stability will support greater economic stability. Curtailing the perceived implicit government guarantee will reducing the Government's contingent liabilities to the banking sector, supporting lower Government borrowing costs.

'Do nothing' option as baseline for costs and benefits

16. All estimates in the table above are gross estimates and are incremental to the 'Do nothing' baseline option (Option 1) described in paragraphs 10-11 above. This baseline includes regulatory reforms that are being implemented independently of the Banking Reform Bill, for example Basel III capital requirements. As the baseline has zero costs and benefits relative to itself, the sections below focus on the Government's lead policy option (Option 2), and discuss how the costs and benefits arise, how they are modelled, as well as assumptions, sensitivities and risks.

[3] Exceptions are when banks were not able to model the impacts based on these policy assumptions, but had to use their own assumptions instead. This is not expected to make a significant difference to the total impact: see paragraph 34 below.

Costs of option 2: Proceed with draft Banking Reform Bill

17. The Government's estimates of the costs of implementing the measures in the Banking Reform Bill are set out in the following sections:

    - Overview: how costs arise;
    - Private cost to UK banks;
    - Social cost (cost to GDP); and
    - Cost to the Exchequer.

Overview: how costs arise

Private cost to UK banks

Curtailment of the perceived implicit government guarantee

18. The principal economic cost to UK banks of implementing the measures in the draft Bill will arise from the withdrawal of the perceived implicit government guarantee enjoyed by banks seen as 'too big to fail'. To the extent that investors believe that the Government would not be willing to see a bank fail, that bank enjoys a perceived implicit guarantee, which acts to lower the bank's cost of funding as well as the level of capital that the market would require it to hold. Academic estimates of the value of this perceived implicit guarantee range from £6bn to £100bn per annum.[4]

19. Some progress has been made in curtailing the perceived implicit guarantee; it can be argued that the implementation of the Special Resolution Regime (SRR)[5] has already sent a strong signal to the market that banks cannot expect to benefit from taxpayer-funded bail-outs to the same degree as previously. But there is no consensus on the extent to which this has already been priced in by the market. Implementation of the measures in the Banking Reform Bill will curtail the perceived implicit government guarantee, by making banks more resilient and resolvable.

Operational cost of structural separation

20. Banks may face a loss of diversification in the long term as they will have less ability to cross-subsidise or cross-sell services between the ring-fenced and non-ring-fenced bank. There will also be upfront transitional costs (such as establishing new subsidiaries) and ongoing costs of operating two entities rather than one (such as operating separate IT platforms).

Social cost (cost to GDP)

21. To the extent that costs to banks arise from the curtailment of the perceived implicit government guarantee, they should not constitute a social cost. This is because withdrawing the perceived implicit guarantee withdraws a subsidy from Government to banks, and thus transfers from Government to banks the full costs of the risks banks take. This is therefore a transfer of cost within the economy, which should not affect the size of the economy overall. The social cost of implementing the measures in the Banking Reform Bill is therefore expected to be less than the private cost to banks. To the extent that subsidies introduce economic inefficiency, it is likely that their removal should yield an economic benefit.

22. Only a portion of the private costs to banks are therefore expected to pass through to GDP, primarily via changes in the price and quantity of credit, as banks pass increased private costs on to customers through prices. By increasing the cost of servicing debt for households and the cost of capital for business, higher credit prices will impact on both household consumption and business investment, and hence GDP. (There

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[4] 'The Implicit Subsidy to Banks', Financial Stability Paper 15, Bank of England, May 2012.

[5] For more details on the SRR see: http://www.bankofengland.co.uk/financialstability/Pages/role/risk_reduction/srr/default.aspx

may also be impacts from banks passing higher costs to shareholders (via lower returns) or employees (via lower pay)).

Cost to the Exchequer

23. In the long run, the principal determinant of tax receipts is GDP, so all else being equal a lower level of GDP will result in lower tax receipts for the Exchequer. Higher private costs to banks that are partially publicly owned (such as RBS and Lloyds Banking Group) could also impact on their share prices, and thus the value of the Government's shareholdings.

Gross costs

24. It is important to note that the costs described here are gross costs, i.e. they take no account of the benefits to society, GDP or the Exchequer of greater financial stability as a result of implementing the measures in the Banking Reform Bill. These benefits are discussed at paragraphs 71-80 below.

Private cost to UK banks

Summary of private cost to UK banks

25. The Government estimates that the total private cost to UK banks of the measures in the draft Bill will be in the range £2bn-£5bn per year, with one-off transitional costs in the range £1.5bn-£2.5bn.

26. The following sections set out the Government's estimates of the private costs to UK banks of the measures in the draft Bill, discussing in turn the costs of:

- Ring-fencing;
- Depositor preference; and
- Framework for imposition of debt requirements by the regulator.

Ring-fencing

Summary of private cost

27. The Government estimates that the aggregate private cost of ring-fencing to UK banks will be in the range £1.7bn-£4.4bn per year, with one-off transitional costs in the range £1.5bn-£2.5bn.

Modelling the cost to UK banks of ring-fencing

28. The costs to banks of ring-fencing have been modelled in four elements:

- Capital Costs: to meet separate capital requirements for ring-fenced and non-ring-fenced banks, banking groups may need to hold more capital in aggregate than in the baseline scenario, generating an ongoing cost.
- Funding Costs: following ring-fencing, the ongoing cost of wholesale funding for non-ring-fenced banks may rise, as deposits are separated into the ring-fence and as investors perceive non-ring-fenced banks as riskier and more volatile. Conversely, however, the funding cost of ring-fenced banks may fall, as investors see them as better capitalised and less volatile. There may also be a quantity effect on banks' funding requirements as higher levels of capital displace some wholesale debt on the liabilities side of their balance sheets.
- Operational Costs: banks may incur additional ongoing operating costs from ring-fencing, for example through needing to operate separate administrative systems for ring-fenced and non-ring-fenced entities.
- Transitional Costs: restructuring in order to meet ring-fencing requirements may involve one-off costs in creating new legal entities and administrative structure, transferring business units etc.

29. The **capital and funding costs** of ring-fencing were estimated by drawing on the results of extensive scenario modelling commissioned from the major affected UK banks, simulating the effects of ring-fencing. The banks were asked to model their future balance sheets first under the regulatory conditions set out for the baseline scenario (Option 1), and then in a scenario in which ring-fencing was in force (according to the regulatory assumptions described in paragraphs 33-35 below). To reflect the flexible nature of the ring-fence, banks were left free to decide whether permitted activities (for example household and corporate lending, large corporate deposits) were to be placed in their ring-fenced or non-ring-fenced entities, according to their own preferred commercial strategies.

30. On the basis of this scenario modelling, the Government calculated the aggregate additional capital required by all the affected banks: multiplying this by an assumed range for the cost of capital gave the incremental annual capital cost. The banks' balance sheet scenario modelling also gave the change in the quantity of wholesale funding required by the different banks relative to the baseline. Applying assumptions for the impact of ring-fencing on the cost of funding for ring-fenced and non-ring-fenced banks gave the incremental annual funding cost of ring-fencing.

31. Separately, the major affected banks were asked to provide estimates of the incremental **operational and transitional costs**. From these estimates, the Government drew ranges for the costs per bank, and calculated aggregate cost ranges across all affected banks.

32. According to this modelling approach, the breakdown of private costs of **ring-fencing** into capital, funding, operational and transitional costs is as summarised in the table below:

Ongoing Costs, per year	LOW	HIGH
Capital	£1.5bn	£3bn
Funding	-£170m	£150m
Operational	£400m	£1.2bn
TOTAL ONGOING COST, per year	£1.7bn	£4.4bn
Transitional Cost (one-off)	£1.5bn	£2.5bn

Assumptions, risks and sensitivities: Ring-fencing

Ring-fencing requirements determined by secondary legislation and regulatory rules

33. As noted above (paragraphs 13-15), the enabling nature of the draft Banking Reform Bill requires a number of assumptions to be made about the content of secondary legislation and regulatory rules in order to model the design and impact of the ring-fence. For the purposes of this IA, it was generally assumed that secondary legislation and rules would follow the policy set out in the Banking Reform White Paper.

34. There were two exceptions to this: the thresholds for determining whether a business qualifies as an SME, and whether an individual may be considered a private banking customer for the purpose of ring-fencing. In both cases, the banks lacked the data to model thresholds prescribed by the Government, and instead had to use their own proprietary definitions of small businesses and wealth/private banking customers. The affected banks expressed a view, however, that the impact on the balance sheet scenarios of using these definitions instead of prescribed assumptions would be minimal.

35. A full list of the assumptions made about the content of secondary legislation and rules for the ring-fence modelling scenario is set out at Annex A below.

Cost and availability of capital

36. For the annual cost of equity capital, an assumed range of 8 per cent – 16 per cent has been used, a range based around a long-run historical average cost of equity[6] to banks of 11.5 per cent, used by the FSA.[7]

[6] Rather than the opportunity cost of equity over debt.
[7] 'Strengthening Capital Standards 3 - further consultation on CRD3', FSA consultation paper CP11/09

37. It has also been assumed that the additional capital required to comply with ring-fencing is available to banks. The Government estimates that the total amount of extra equity required by UK banks is approximately £19bn. Banks have a range of options for increasing their equity levels, including raising capital externally (for example by issuing new shares) and generating equity internally through retained earnings. With several years until the final deadline for compliance, the Government is confident that banks will be able to raise the additional equity required.

Wholesale funding cost assumptions

38. The impact of ring-fencing on banks' funding costs is difficult to forecast precisely. As discussed in paragraph 28 above, it is likely that funding costs for ring-fenced banks will fall, while funding costs for non-ring-fenced banks will rise as a result of ring-fencing. Meanwhile, both ring-fenced and non-ring-fenced banks may experience a loss of diversification in their revenues, which may push funding costs up. Changes in banks' balance sheet structures may also affect the annual cost of funding by changing the amount of wholesale funding that different banks require.

39. In modelling the impact of ring-fencing on funding costs, the Government has used estimates provided by the major UK banks of the likely effect on their funding costs, as well as drawing on some external analysis.[8] On the basis of this information, for the purposes of this IA the Government has used the following assumed ranges:

    - For ring-fenced banks: a change of between -10 basis points (bps) and 0bps in the cost of subordinated, long-term unsecured and short-term unsecured debt.
    - For non-ring-fenced banks: a change of between 0bps and 75bps in the cost of subordinated, long-term unsecured and short-term unsecured debt.

40. It is important to note that these estimated impacts on banks' funding costs do not include the impact of bail-in. This is because the draft Bill does not include provision for a bail-in tool: as noted in paragraph 7 above, it is expected that bail-in will be implemented via transposition of the European RRD. This is one area of difference between the cost estimates in this IA and those in the IA accompanying the Banking Reform White Paper, which covered the full ICB package, including bail-in.

Operational costs and tax implications

41. Based on estimates supplied by banks, the Government has assumed that operational costs for the large UK banks of complying with ring-fencing range from £100m-£300m per bank per year. Costs are likely to vary depending on banks' business models, including their choices over the location of the ring-fence.

42. The Government has identified potential tax implications of implementing the ring-fence, including how banks use their trading losses to offset profits in future years (as ring-fenced banks will be separate entities from non-ring-fenced banks) and the impact of removing ring-fenced banks from their VAT groups. The Government is continuing to consult with industry on options to mitigate the potential costs of these tax implications, and expects to bring forward measures in a future Finance Bill. For the purposes of this IA, therefore, it has been assumed that these costs will be zero.

Transitional costs

43. The costs of restructuring to comply with ring-fencing are likely to vary from bank to bank, depending on their chosen post-ring-fencing business model. The Government, using estimates provided by the large UK banks, has assumed a range of restructuring costs for the large UK banks of £50m-£500m per bank.

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[8] RBS Equity Research, 'Banks: Avoiding Strangulation', 2011

Depositor preference

Summary of private cost

44. The Government estimates that the aggregate private cost of depositor preference to UK banks will be in the range £0.3bn-£0.7bn per year.

Modelling the private cost of depositor preference

45. Preferring FSCS-protected deposits (and thus the FSCS standing in their place) in the event of a bank becoming insolvent will likely reduce the expected recovery of the bank's other (current) senior unsecured creditors, who will likely demand a higher price to compensate them for the increased risk in lending to the bank. Thus the cost of wholesale funding for the bank will likely rise. Depositor preference is, however, just one element of the ICB's recommendations on loss-absorbency that is expected to impact on banks' costs of wholesale funding. For example, a bail-in tool would also expose senior unsecured creditors to greater risks of loss, increasing banks' funding costs. To some extent, these additional costs may also be offset by the effects of behavioural responses by customers, for example if depositor preference made customers more willing to place deposits in banks at lower rates of interest, reducing the cost to banks of deposit funding. Such behavioural effects are, however, uncertain and difficult to forecast with any precision, so have been excluded for the purposes of this IA.

46. Isolating the impacts on banks' funding costs of different elements of the ICB's recommendations is therefore difficult, and requires that assumptions be made about which portions of an increase in funding costs should be attributed to which particular measures. Given the overlapping impacts of the different policy measures, any assumption made would be to some extent subjective. For the purposes of this IA,[9] the costs were attributed by modelling the costs of a bail-in tool as falling on long-term senior unsecured debt,[10] and the costs of depositor preference as falling on short-term unsecured funding. As noted above, the draft Bill does not include a bail-in tool (which the Government intends to deliver via transposition of EU legislation), so the cost of bail-in is not included in this IA.

47. To model the cost of depositor preference, the Government commissioned the major UK banks to estimate the impact on the cost of short-term unsecured funding of preferring FSCS-insured deposits. From the estimates supplied, the Government drew a range for the basis point impact, from 25bps to 50bps. Applying this to the quantities of short-term funding included in each bank's modelled balance sheets gave the annual cost, which was then aggregated across all the major UK banks.

Assumptions, risks and sensitivities: Depositor preference

Impact of depositor preference on banks' liabilities to pension schemes in insolvency

48. Preferring FSCS-protected deposits in insolvency would also subordinate to those deposits (or to the FSCS standing in their place) the claims on an insolvent bank of the bank's pension scheme to make good any deficit of the pension scheme. Pension scheme trustees could, therefore, respond to depositor preference by demanding a greater front-loading of payments into pension schemes by banks that currently have pension deficits, to eliminate those deficits sooner than under current plans. In the short or medium term, this could create an additional cost for banks.

49. The scale and nature of this potential short- or medium-term cost is, however, uncertain. How far banks will have to make additional payments into their pension schemes, if at all, will depend on the outcome of negotiations between each bank and the trustees of its pension scheme.

50. Also, to a significant extent, the short-term costs of any additional payments that banks may need to make into pension schemes will likely be costs brought forward rather than entirely new costs, as trustees will be demanding early reduction of already existing pension deficits (which banks are already committed to

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[9] As well as for the purposes of the Government's previous modelling of the costs of the entire ICB package, as set out in the IA accompanying the Banking Reform White Paper.

[10] 'Long-term' being defined as with a maturity of one year or more.

eliminating). Any impact that depositor preference has on this issue may thus be largely on the timing, not the quantum, of banks' payments to their pension schemes. In the long-run, it is expected that pension scheme deficits must be eliminated entirely, at which point the cost to banks will fall to zero. For the purposes of this IA, therefore, the cost to banks of preferring FSCS-insured deposits to pension scheme liabilities has been assumed to be zero.

Framework for imposition of debt requirements

Summary of private cost

51. The ICB recommended that large banks be required to maintain Primary Loss-Absorbing Capacity (PLAC) of at least 17 per cent of risk-weighted assets (RWAs), consisting of regulatory capital plus debt that is clearly subject to bail-in.[11] Minimum regulatory capital requirements will be set in EU law (CRD IV/CRR, which will implement the Basel III minimum capital requirements in the EU). It is expected that the European RRD will also empower member states to impose requirements on banks to hold minimum levels of loss-absorbing instruments: the Government expects that this will be the means by which the ICB's recommendation on PLAC will be delivered.

52. The draft Bill will give HM Treasury power to establish the framework for the regulator to impose minimum debt requirements, subject to the final form of the RRD. Establishing a framework for regulatory action is not expected of itself to impose any additional costs on UK banks (and when exercising its powers, the regulator will need to consider the costs and benefits of any potential course of action).

Assumptions, risks and sensitivities: Framework for debt requirements

Regulatory assumptions on loss-absorbency

53. To be able to model their balance sheets in a ring-fencing scenario, it was necessary for banks to make assumptions about the minimum requirements for regulatory capital and PLAC. For the purposes of this modelling, therefore, the Government asked all the major UK banks to assume minimum loss-absorbency requirements equal to the Basel III minima for capital and 19 per cent of RWAs for total PLAC (equal to a regulatory minimum of 17 per cent plus a 2 per cent management buffer). More detail on the assumptions for loss-absorbency is included in Annex A below.

General assumptions for modelling private cost to banks

Static modelling of bank balance sheets

54. The modelling of banks' balance sheets for the purposes of this IA was static, i.e. it took no account of potential behavioural responses by either bank management or bank customers. So the only changes to banks' balance sheets were those required to comply with ICB requirements or to meet perceived market expectations (for example sufficient capital to ensure a bank could attain a high enough credit rating in order to operate effectively in the market: in both baseline and ring-fence scenarios, some banks assumed that market pressures would require them to hold capital above regulatory minima).

55. In practice there may be more extensive behavioural responses both from customers (switching between banks, or between ring-fenced and non-ring-fenced banks) and from banks (adjusting their business lines in response to market dynamics and the actions of competitors). These behavioural responses are inherently uncertain, and so difficult to quantify with confidence. No account has therefore been taken of these behavioural responses in modelling for this IA.

[11] Provided they satisfied minimum regulatory capital requirements, banks would have the choice to meet any shortfall between these capital requirements and their PLAC requirement through holding additional regulatory capital or eligible debt instruments.

Crisis response and stress

56. For the purposes of this IA, modelling has focussed exclusively on the long-run costs of the measures in the draft Bill in a 'steady state', i.e. when markets are functioning normally. It is not possible to model with any precision the impact of these measures in a stress scenario, as defining what constitutes a stress scenario, and determining the extent to which such a scenario has an effect on different banks in the market, are subjective and highly sensitive to assumptions. The impact of these measures in a stress scenario will also likely vary significantly from bank to bank.

57. In theory, curtailing the perceived implicit government guarantee should exaggerate the movement of funds in a stress from banks perceived by market participants as high risk to those perceived as less risky. Such movement could be seen as encouraging more efficient pricing of funds in a stress, and could lower the cost of funds for low-risk banks. At the same time, ring-fencing should make individual banks and the system as a whole more resilient to stress, as a result of higher capital levels and reduced channels of contagion between banks. This should reduce the extent to which funding costs would rise in a stress scenario. There are, however, too many uncertainties involved for meaningful modelling of these different effects, which are therefore excluded from this IA.

Social cost (cost to GDP)

Summary of GDP cost

58. The increase in banks' private costs is estimated to produce a gross[12] **reduction in the long-run level of GDP in the range 0.04% to 0.1%**, equivalent to an average[13] annual cost to GDP of **£0.4bn-£1.1bn** relative to the 'regulatory environment' baseline scenario. The present value cost to GDP is estimated at £7bn-£20bn.

Modelling the cost to GDP

59. Having estimated the aggregate private cost to UK banks of implementing the measures in the draft Bill, the Government then estimated the impact of these costs on GDP from modelling by the FSA using the NiGEM model.[14] NiGEM is an empirically-based econometric model that estimates the impact on credit prices and economic output as a result of changes to banks' minimum capital ratios, funding and operational costs. The model uses long-run historical data to determine the impact of changes in bank costs on the wider economy. As noted above (see paragraph 21), not all of the private cost to banks will represent a social cost (some costs are being transferred within the economy): hence the social cost of the measures in the draft Bill is expected to be lower than the private cost.

Assumptions, risks and sensitivities

NiGEM modelling of long-run GDP cost

60. The NiGEM model calculates the cost to GDP on the basis that banks pass on to consumers near to 100 per cent of the additional private costs. This assumption is based upon the historical evidence that underpins the model. If this assumption is made, then it suggests that little, if any, costs directly impact banks' profits, in the first instance. The Government recognises that using historical evidence may not truly reflect future trends, and so the pass through in the future may not be the same. Also, how banks pass on any increase in their private costs is a commercial decision and so cannot be forecast with certainty.

[12] I.e. not taking account of the benefits to GDP of the measures in the draft Bill.

[13] Over a 30-year forecast period: see 'Calculating Present Value of GDP cost' section below.

[14] The NiGEM model is a macroeconometric model created by the National Institute of Economic and Social Research (NIESR). See Appendix 1 of the FSA's Occasional Paper 38 (http://www.fsa.gov.uk/pubs/occpapers/op38.pdf) and Occasional Paper 42 (http://www.fsa.gov.uk/static/pubs/occpapers/op42.pdf), for more details of the FSA's modelling with NiGEM.

Calculating present value of GDP cost

61. To calculate their present values, the costs and benefits have been assumed to persist for 30 years, discounted according to HM Treasury Green Book guidance.[15] The Government has made the following assumptions about when the different costs that banks face arise:

- transitional costs are incurred in the first two years of the transition period of the policy;
- operational ongoing costs are zero in the first two years, but are then constant each year thereafter; and
- capital costs increase steadily year on year until reaching the point at which banks hold sufficient capital to meet the policy requirements by the deadline for compliance in 2019. From this point, the capital costs are constant each year.

62. The Government's intention is for the measures in the draft Bill to constitute a permanent reform to the banking sector. The Government recognises that the present value costs and benefits of the policy will extend (albeit at diminishing levels) beyond the 30-year policy period chosen. The 30-year time period has been selected solely to show an illustrative present value calculation.

Short-run GDP impact

63. In the long run, by making UK banks more resilient and resolvable and thus curtailing the perceived implicit government guarantee, implementing the measures in the draft Bill are expected to support more efficient supply of credit to the economy. There is a risk that in the short-term however, banks could respond to the new regulations by shrinking their balance sheets and cutting back on lending to the real economy. External estimates suggest that there can be a cost to GDP when banks are required to increase capital requirements in a short period of time.[16]

64. It is to mitigate this risk that the Government has established 2019 as the deadline for compliance with ring-fencing, in line with the recommendations of the ICB. Given this, the potential short-term impact of the draft Bill has been excluded from this IA.

Cost to the Exchequer

Summary of Exchequer cost

65. Implementing the measures in the draft Bill is estimated to produce a gross **reduction in tax receipts of £150m-£400m per year** and a **reduction in the value of the Government's shareholdings in partially publicly-owned banks of £2bn-£5bn**, relative to the 'do nothing' baseline.

Tax receipts

66. In the long run, the main driver of the level of annual tax receipts is the level of GDP: all else being equal, lower GDP would therefore result in lower tax receipts for the Exchequer. Having estimated the impact on GDP of the measures in the draft Bill as described above, the Government estimated the impact on tax receipts by applying the long-run average tax:GDP ratio (35.2 per cent over the last 20 years). This gives a reduction in tax receipts of £150m-£400m per year.

67. This approach assumes that banks pass on 100 per cent of the additional costs to customers (as assumed for the NiGEM modelling), and that the impact on tax receipts is all therefore felt through the impact on GDP. It is possible, however, that banks may choose to internalise some of the additional costs, pushing down their profits, or to pass them on to employees instead, pushing down their pay. These possible effects could push down receipts from corporation tax and income tax/NICs respectively. The extent to

[15] HM Treasury Green Book: http://www.hm-treasury.gov.uk/data_greenbook_index.htm.

[16] For example, "*Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements*", Basel Committee on Banking Supervision, December 2010.

which banks do internalise costs (or pass them on to employees) will be a commercial decision for managements, which the Government cannot forecast with certainty. However, it is not clear that there would be a marked difference in total tax receipts if some of the additional costs were to be passed through to bank profits or bankers' remuneration, as in these circumstances the pass-through of costs to customers (and thence to GDP and wider tax receipts) would be reduced, which may offset any reduction in tax receipts specifically from banks or their employees.

Government shareholdings in RBS and Lloyds Banking Group

68. The additional costs of the measures in the draft Bill are likely to impact on the value of the Government's stakes in RBS and Lloyds Banking Group, although this effect may be to some extent mitigated if equity investors perceive them to be less risky following the reforms. To the extent that proceeding with the Bill reduces the eventual proceeds from selling the Government's shareholdings, there will be an additional cost to the public finances, which will crystallise when the shareholdings are sold.

69. The Government has used estimates provided by UK Financial Investments Ltd (UKFI) to assess the potential loss to the value of its shareholdings arising from the measures in the Bill. These estimates are based on standard bank valuation methodologies, using various assumptions about the potential impact on the banks' return on equity (which will be affected by changes to their funding and operating costs, amongst other factors), cost of equity and additional capital requirements. It is important to note that this loss is not relative to the current market value of the Government's shareholdings in RBS and Lloyds Banking Group. Rather, the estimated loss attributable to the Bill is relative to the counterfactual future scenario in which the Bill measures are not implemented (consistent with other cost and benefit estimates in this IA). With markets anticipating that the Government will implement the recommendations of the ICB (including the measures in the draft Bill), it is likely that the impact is already largely or entirely factored into the two banks' current market share prices.

70. UKFI's estimates of the value impact are subject to a range of caveats. First, in line with the rest of this IA, they <u>do not take account of the costs to banks of bail-in</u>, as this is not included in the draft Bill. Also consistent with the approach taken elsewhere in this IA, the modelling does not take account of any behavioural responses by bank management (e.g. reconfiguring business lines) or customers (e.g. switching banks), as such effects cannot be estimated with any confidence. It also assumes that there is no pass through of costs to customers: given that the Government's estimate of the impact on GDP of the Bill measures does assume that costs are passed through, there is therefore likely to be some double-counting of costs. Given these limitations, the UKFI estimates should be viewed as broadly indicative of the maximum extent of shareholder costs, rather than precise forecasts. On the basis of these assumptions, the Government estimates that the measures in the draft Bill could lead to a reduction in the value of the Government's shareholdings in RBS and Lloyds of around £2bn-£5bn.

Benefits of Option 2: Proceed with draft Banking Reform Bill

Economic benefits of increased financial stability

71. The aim of the draft Bill is to promote greater financial stability in the UK, by curtailing the perceived implicit government guarantee to banks. Curtailing the perceived implicit guarantee will reduce banks' incentives to take on excessive risks, tackling the moral hazard that the perception of a guarantee creates. The measures in the draft Bill will also make banks more resilient to shocks (reducing the likelihood of bank failure) and more easily resolvable in the event of failure (reducing the impact on the economy and the public finances of bank failure).

72. The measures in the draft Bill should therefore make banking crises less frequent and less costly to the economy in the future. This would result in a higher level of GDP in the long run (and as a consequence, all else equal, higher tax receipts). Independent of the level of GDP, there is likely to be a welfare benefit from a more stable path for GDP, as individuals and firms value stability of income as well as income levels. Greater stability of GDP could also increase confidence in the economy and provide a better environment for investment. Curtailing the perceived implicit guarantee should also bring a benefit to the Government's borrowing costs, as sovereign debt investors see a reduction in the Government's contingent liability to the banking sector.

Challenges in quantifying the benefits of increased financial stability

73. The precise costs of financial instability (and hence the benefits of greater stability) are, however, inherently uncertain, as they depend on how often financial crises will occur in the future, and what form those crises will take, which cannot be known in advance. Academic estimates of the costs of crises reviewed by the ICB vary very widely, from 0.56 per cent of GDP per annum to 15.7 per cent, reflecting these uncertainties.

74. It is, however, clear that systemic financial crises can be extremely costly when they do occur, both to GDP and to the public finances. For example, according to the Office for Budget Responsibility (OBR), the banking crisis of 2008-09 led to a peak-to-trough fall in GDP of 7.1 per cent,[17] and the OBR forecast that potential output in 2016 will be 11 per cent below its extrapolated pre-crisis trend.[18] During the crisis, as GDP, and with it tax receipts, fell sharply, public spending (based on the plans set out in the 2007 Comprehensive Spending Review) increased rapidly as a share of GDP, which caused a sharp deterioration in the public finances. In addition, the public finances faced the very substantial costs of direct support to the UK financial system, which at peak amounted to over £120bn in cash support and a further £1tn in guarantees and contingent liabilities.[19]

Illustrative calculations of benefits of improved financial stability

75. Given the uncertainties around the costs of future crises, meaningful modelling of the benefits of improved financial stability is not possible. It is, however, possible to give a sense of the scale of the benefits by means of illustrative calculations.

76. In its final report, the ICB estimated the annual cost to GDP of periodic financial crises, on the basis of academic studies. Drawing on the academic literature, the ICB calculated average values for the probability of a crisis occurring in a given year (4.5 per cent) and the present value cost to GDP of a crisis occurring (63 per cent of GDP). These gave an annual cost of around 3 per cent of GDP, or around £40bn per year in 2010 terms.[20]

77. Using the ICB's estimates, it is possible to produce an illustrative calculation of the scale of the benefits that increased financial stability would bring, in the form of less frequent and/or less costly financial crises in the

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[17] *Economic and Fiscal Outlook*, OBR November 2011.

[18] *Economic and Fiscal Outlook*, OBR March 2012.

[19] *The Comptroller and Auditor General's Report on Accounts to the House of Commons: The Financial Stability Interventions*, National Audit Office, July 2011.

[20] ICB *Final Report*, paragraphs 5.8 and 5.67.

future. An illustrative calculation of this sort was included in the IA accompanying the June 2012 Banking Reform White Paper. Assuming that other regulatory reforms (such as those in the regulatory baseline for the 'do nothing' option) had already reduced the annual cost of crises by 30 per cent, if implementing the ICB's recommendations further reduced the probability of crises by 10 per cent (by making the banking system more resilient) and reduced the GDP impact of crises by 25 per cent (by making banks more resolvable in the event of failure), this would yield an incremental benefit to UK GDP of 0.64 per cent, which would be equivalent to £9.5bn in 2010-11 GDP terms. To adjust this illustrative calculation for the exclusion of those elements of the ICB's recommendations not included in the draft Bill (for example bail-in), if baseline regulatory reforms reduced the annual cost of crises by 30 per cent, and if the measures in the draft Bill further reduced the probability of crises by 10 per cent and the GDP impact of crises by 15 per cent, this would yield an incremental benefit to UK GDP of 0.47 per cent, which would be equivalent to £6.9bn in 2010-11 GDP terms.

Sensitivity analysis for illustrative calculation

78. Any calculation of this sort is naturally sensitive to the assumptions used. A particular sensitivity is to the value used for the present value GDP costs of crises when they occur: if, instead of the average value calculated by the ICB, the maximum value included in the academic literature (302 per cent) is used, the annual cost of crises rises to 14 per cent of GDP, and the incremental benefit of the measures in the draft Bill (calculated on the basis of the assumptions in paragraph 77 above) rises to £33bn in 2010-11 GDP terms.

79. The illustrative calculation is also sensitive to the assumed reduction in the frequency and GDP impact of crises produced by the 'baseline' regulatory reforms and by the measures in the draft Bill. All else equal, each 1 percentage point increase in the assumed benefit of regulatory reforms in the baseline would reduce the incremental GDP benefit of the draft Bill measures by around 0.02 percentage points or £100m in 2010-11 GDP terms. If the baseline reforms assumption is held constant, then each 1 percentage point change in the impact of the draft Bill measures on the frequency and GDP impact of future crises would cause the incremental benefit to change by 0.017 percentage points and 0.018 percentage points (£250m and £260m in 2010-11 GDP terms), respectively.

80. As a further illustration of how even small reductions in financial instability can yield very large benefits to the economy (given the scale of the costs of financial crises), it is also possible to calculate the least impact that the measures in the draft Bill need have for them still yield a net-benefit to GDP. Taking the ICB's estimate of the annual cost of financial crises, and assuming that 'baseline' regulatory reforms reduce this cost by 30 per cent (as in paragraph 77 above), to produce an incremental benefit to GDP of 0.1 per cent (the upper end of the estimated range of GDP costs), the measures in the draft Bill need only reduce the probability of future crises by 2.6 per cent and their GDP impact by 2.6 per cent.

Conclusion on costs and benefits of draft Banking Reform Bill

81. Weighing the estimated costs and benefit of the measures in the draft Bill, the Government concludes that the benefits of proceeding with the Bill outweigh the costs, and thus that proceeding with the Bill will generate net benefits relative to the baseline.

Rationale and evidence that justify the level of analysis in this IA

Proportionality

82. The measures included in the Banking Reform Bill are the product of extensive policy development and consultation by both the ICB and the Government over a period of more than 2 years. During this period, a wide range of alternative approaches have been considered, including alternative models for structural reform of banks (e.g. full separation of retail and investment banking, full reserve banking and narrow banking considered by the ICB) and different options for the calibration of the ring-fence and depositor preference (e.g. alternative calibrations considered for the Government's Banking Reform White Paper).

83. With these alternatives having been discarded at earlier stages, analysis for this IA has focussed exclusively on the impact of the measures included in the draft Bill, which have been compared to a 'Do Nothing' alternative.

Wider impacts

84. There are a number of wider impacts that have been considered. These are detailed below.

Impact on competition in the UK banking sector

85. Reducing the perceived implicit government guarantee for large UK banks that are seen as 'too big to fail' should support competition in the UK banking sector, as the perceived implicit guarantee gives a competitive advantage to large banks over smaller competitors, who are not seen as benefiting from an implicit guarantee. Reducing the perceived implicit guarantee will thus reduce the competitive disadvantage for smaller banks and should support greater competition in the market.

Distribution of the impact in the market

86. The aggregate private costs to the banking industry are £2bn - £5bn. The cost to each bank in the industry as a result of the policy option will be different, as they have different business models. There is, however, some flexibility in how banks can adjust their businesses to the requirements of ring-fencing, which gives them scope to find an optimal business model. It is not possible to disaggregate the impact for each of the UK banks affected, as this is commercially sensitive data.

Impact on the labour market

87. Imposing additional costs on UK banks could have consequences for the labour market, to the extent that banks choose to pass higher costs on to their employees by reducing overall remuneration levels. However, it is not clear whether, or to what extent, banks will in fact pass costs on to employees: this would be a commercial decision for each bank, which it is not possible for the Government to forecast with any certainty.

Business borrowing distortions

88. An increase in banks' private costs may lead to an increase in lending rates. Larger businesses that are not reliant upon funding through these banks, and can access funds from alternative sources, would be less affected by the increase in bank lending costs than smaller businesses who may be more dependent on funding from banks. Whether and how banks choose to pass on additional costs to their customers is a commercial decision for each bank, which it is not possible for the Government to forecast with any certainty.

Impact on competitiveness of UK banking sector

89. The Government believes that the measures in the Banking Reform Bill will enhance competitiveness in the UK financial sector in the long run, through greater financial and macroeconomic stability. It is imperative that such regulatory reform is introduced to make the UK banking sector more stable and intervention at the taxpayers' expense less likely in future.

Expected finance and resource impact on other Departments

90. Enforcing and policing the ring fence will incur costs to the PRA. The FSA has estimated that the upfront cost of implementing the ICB's recommendations to the regulator to be no more than £20m, with subsequent ongoing costs of around £2m per annum. The costs of enforcing just the elements of the ICB's recommendations included in the draft Bill will likely be somewhat lower.

Equality impact

91. The Government has considered its obligations under the Equalities Act 2010. The Government does not believe these measures will impact upon discrimination, equality of opportunity or good relations towards people who share relevant protected characteristics under that act.

92. The Government considers that the proposals are compatible with the Convention rights protected under the Human Rights Act 1998.

Summary and implementation plan

Chosen policy option

93. The Government therefore proposes to proceed with the draft Bill (Option 2). The Government believes that implementing these measures will deliver net benefits relative to the baseline.

Implementation plan

94. The draft Bill has been submitted for Pre-Legislative Scrutiny to the Parliamentary Commission on Banking Standards, which will report on the draft Bill no later than 18 December 2012.

95. Having regard to recommendations from this Pre-Legislative Scrutiny process, the Government will introduce the Banking Reform Bill to Parliament early in 2013. At introduction, the Bill will be accompanied by a further IA. As noted in paragraph 15 above, when secondary legislation under the draft Bill is brought forward for consultation later in 2013, this will also be accompanied by further IAs.

Annex A

Assumptions on secondary legislation and regulatory rules

Listed below are the assumptions the Government has made in its modelling for this IA of the requirements that will be imposed by secondary legislation and rules. The assumptions below do not necessarily reflect the Government's final position in these areas.

Ring-fencing:

Issue	Modelling Assumption for this IA
De minimis exemption from ring-fencing	Banks with mandated deposits of less than £25bn exempt from ring-fencing.
Definition of SME	Banks made own assumptions
Definition of private banking customer	Banks made own assumptions
Prohibited/Permitted Services	Ring-fenced banks (RFBs) may deal in investments as principal and enter into derivative contracts for the purposes of hedging risks arising from banking activities and/or for purposes of liquidity management. RFBs permitted to offer simple risk-management products to customers, subject to safeguards.
Geographical scope of ring-fence	RFBs not permitted to undertake non-EEA transactions, defined as transactions booked outside the EEA.[21]
Status of Channel Islands	Channel Islands treated as within EEA for purposes of ring-fence geographical scope.
Restrictions on RFB exposure to financial institutions	RFBs prohibited from providing services to any financial institutions except those that are SMEs.
Intra-group exposure limits	Exposures between RFB and rest of group subject to standard large exposure limits i.e. may not exceed 25% of regulatory capital.
Wholesale funding limit for RFBs	No more than 50% of RFB funding can be wholesale.

[21] Given the data available to them, banks were only able to model the geographical scope of the ring-fence using booking location, but this is not the basis on which the Government expects to define this.

Loss-absorbency:

Issue	Modelling Assumption for this IA
Regulatory capital requirements	Basel III minimum requirements: • Min Common Equity Tier 1 (CET1) ratio: 7% RWAs (=4.5% 'hard' minimum plus 2.5% Capital Conservation Buffer); • Min Tier1 ratio: 8.5% RWAs; • Min Total Capital ratio: 10.5% RWAs. G-SIB surcharge: • Min CET1 ratio increased by 2.5%. Ring-Fence Buffer (for UK RFBs): • Min CET1 ratio increased by 3%. (where a UK RFB is also a G-SIB, the higher of the two additional capital requirements will apply) Leverage Ratio: • Min Tier 1 Capital to Total Exposures: 3%. Management Buffer: • Min Total Capital ratio increased by 2%.
PLAC requirement	Regulatory minimum PLAC (=regulatory capital plus best-quality loss-absorbing debt) ratio: 17% RWAs; Plus management buffer of 2% RWAs, giving total PLAC requirement of 19% RWAs.
PLAC requirement for UK-headquartered G-SIBs	Total PLAC requirement applies at Group level for UK G-SIBs, but with exemption for overseas RWAs where overseas operations do not threaten EEA financial stability.

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