HM Treasury

Department for Business Innovation & Skills

Banking reform:

draft secondary legislation

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July 2013

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draft secondary legislation

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1 Introduction

1.1 The Financial Services (Banking Reform) Bill was introduced to Parliament on 4 February 2013 with the aim of establishing a more resilient, stable, and competitive banking sector; to reduce the severity of a future financial crisis, and to protect taxpayers in the event of such a crisis. The Bill has completed its passage through the House of Commons, and is currently before the House of Lords.[1]

1.2 The Bill implements those recommendations of the Independent Commission on Banking (ICB) which require legislation:

- the introduction of a ring-fence around retail deposits to separate important everyday banking activities from investment and wholesale banking activities;
- preference for deposits protected under the Financial Services Compensation Scheme if a bank enters insolvency; and
- powers for the Government to regulate the way in which debt requirements are imposed on banks, to ensure they are more able to absorb losses.

1.3 The Bill also implements a number of additional policies, including powers to enable HM Treasury expenses incurred as a result of UK participation in international organisations concerned with financial stability or financial services to be reclaimed from the financial services industry.

1.4 The Banking Reform Bill is primarily an enabling Bill, which provides HM Treasury with the requisite powers to implement the policy underlying the Bill through secondary legislation. That policy was set out in the Government's previous publications – the *Banking reform* white paper in June 2012,[2] the draft Bill in October 2012,[3] and the response to the pre-legislative scrutiny report in February 2013.[4] Implementing the majority of the policy detail through secondary legislation allows the Government to respond flexibly to changes in the banking system, and is appropriate given the technical nature of many of the provisions.

1.5 Illustrative drafts of three statutory instruments (the Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order, the Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order, and the Financial Services and Markets Act 2000 (Fees and Prescribed International Organisations) Regulations) were published in March 2013 in order to aid Parliamentary scrutiny of the Bill.[5]

1.6 The Government has continued to develop these instruments, alongside further secondary legislation to be made under the Bill. This paper invites comments on the following four statutory instruments:

[1] The Bill is available at: http://services.parliament.uk/bills/2012-13/financialservicesbankingreform.html

[2] *Banking reform: delivering stability and supporting a sustainable economy* (June 2012), https://www.gov.uk/government/publications/banking-reform-delivering-sustainability-and-supporting-a-sustainable-economy

[3] *Sound banking: delivering reform* (October 2012), https://www.gov.uk/government/publications/draft-financial-services-banking-reform-bill

[4] *Banking reform: a new structure for stability and growth* (February 2013), http://www.official-documents.gov.uk/document/cm85/8545/8545.pdf

[5] Available at: http://webarchive.nationalarchives.gov.uk/20130405170223/http://www.hm-treasury.gov.uk/fin_stability_regreform_icb.htm

Ring-fenced Bodies and Core Activities Order

1.7 This Order will be made under powers in sections 142A, 142B and 142F of the Financial Services and Markets Act 2000 (FSMA), as amended by the Bill, to set the scope of the ring-fence. It defines the proposed *de minimis* threshold below which institutions will be exempted from ring-fencing, and the exemptions which will permit the deposits of larger organisations and high net worth individuals to be held outside the ring-fence.

Excluded Activities and Prohibitions Order

1.8 This Order uses powers under sections 142D, 142E and 142F of FSMA (as amended by the Bill), to define a range of activities that will not be permitted inside the ring-fence, including a prohibition on ring-fenced banks having exposures to certain financial institutions. It also creates a number of exemptions to the excluded activities and prohibitions defined under the Bill, including exemptions to permit ring-fenced banks to sell simple derivatives, and to enable them to manage their own risks.

Banking Reform (Loss Absorbency Requirements) Order

1.9 This Order will be made under powers in sections 142Y and 428(3) of FSMA (as amended by the Bill), to establish the framework through which non-capital primary loss-absorbing capacity (PLAC) requirements (i.e. those PLAC requirements which relate to debt issued by banks that cannot form part of their regulatory capital) will be imposed by the regulator on systemic UK banks and building societies. It includes specific scaling mechanisms and criteria the regulator is to take account of when calibrating non-capital PLAC requirements for different classes of bank; states when the regulator is required to include risk-weighted assets held in non-EEA entities when calculating group debt requirements, where this accords with the requirements in individual firms' resolution strategies; and defines eligible debt instruments which may be the subject of non-capital PLAC requirements. The international regulatory dialogue and development of best practice on creating a credible bail-in mechanism, including appropriate requirements for minimum quantities of loss-absorbing capacity, has been progressing since the ICB published its recommendations, and continues to do so. The Government will of course need to consider any modifications that may be appropriate as a result of developments on international standards or best practice in relation to enhancing banks' loss-absorbency.

Fees and Prescribed International Organisations Regulations

1.10 These Regulations will be made under powers in section 410A of FSMA (as amended by the Bill), to enable expenses incurred by HM Treasury as a result of UK participation in international organisations concerned with financial stability or financial services to be reclaimed from the financial services industry. The Regulations specify the Financial Stability Board as an organisation for which HM Treasury expenses may be claimed, the types of expenses that can be recovered under the power, and the factors that HM Treasury must consider before directing the regulator to impose fees on the industry.

Further secondary legislation

Pensions

1.11 As set out in the 2012 *Banking reform* white paper, the Government intends to make regulations requiring banks to ensure that ring-fenced banks are not (and cannot become) liable for the pension schemes of bodies which are not ring-fenced. This is to prevent pension debts of other group members falling on the ring-fenced bank in the event that those other members fail, which could constitute a channel of financial contagion across the ring-fence. Draft regulations will be published for consultation, following further discussions with the regulators, at a later stage during the Bill's progress through Parliament.

Building societies

1.12 The Government set out its approach to applying the ICB's recommendations to building societies in the 2012 *Future of building societies* white paper. In order to preserve the distinctive nature of the sector, the Government decided to carve building societies out of ring-fencing legislation, and to make any adjustments necessary to the regime for building societies by making appropriate amendments to the Building Societies Act 1986.

1.13 Where ring-fenced banks face tighter restrictions than building societies, imposing these on building societies may be disproportionate. Although there would be a prudential benefit from tightening the restrictions on building societies to bring them into line with those on ring-fenced banks, the costs to building societies would be much greater than the costs to banks, as they could not conduct these activities in a non-ring-fenced entity. These higher costs, which could distort fair competition, may not be justified by the prudential benefits.

1.14 The Government therefore proposes not to make any changes to building societies legislation in connection with the ring-fence, at this stage. However, should it decide that any particular changes are necessary, the Government will have a power under clause 8 to allow it to make provision in relation to building societies for the purposes of ring-fencing, and to apply the PRA's or the FCA's continuity objective when they are exercising functions relating to ring-fencing as applied to building societies. The Government will keep under review the case for making such provision.

Next steps

1.15 The Government remains committed to putting all necessary legislation in place by the end of this Parliament. Following this consultation and the granting of Royal Assent to the Banking Reform Bill, the Government will seek to introduce final versions of these drafts into Parliament as soon as time allows.

How to respond

1.16 The Government seeks views on the secondary legislation published in this document.

1.17 Responses are requested by 9 October 2013. The Government cannot guarantee that responses received after this date will be considered.

1.18 This document is available electronically at: www.gov.uk/treasury. You may make copies of this document without seeking permission. Printed copies of the document can be ordered on request from the address below.

1.19 Responses can be sent by e-mail to: banking.commission@hmtreasury.gsi.gov.uk. Alternatively, they can be posted to:

Banking Reform Bill Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

1.20 When responding, please state whether you are doing so as an individual or representing the views of an organisation. If you are responding on behalf of an organisation, please make clear who the organisation represents and, where applicable, how the views of members were assembled.

Confidentiality

1.21 Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004).

1.22 If you would like the information that you provide to be treated as confidential, please mark this clearly in your response. However, please be aware that under the FOIA, there is a Statutory Code of Practice with which public authorities must comply and which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain why you regard the information you provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances.

1.23 In the case of electronic responses, general confidentiality disclaimers that often appear at the bottom of emails will be disregarded unless an explicit request for confidentiality is made in the body of the response.

2 Ring-fenced bodies and core activities

2.1 The Ring-fenced Bodies and Core Activities Order defines the 'scope' of the ring-fence. It specifies which institutions will be exempt from ring-fencing, which deposits must be held in ring-fenced or exempt banks ('core deposits'), and which may be held by other banks.

2.2 This chapter first explains the definition of 'core deposits'. It then covers those institutions that will be exempt from ring-fencing, specifically small banks and non-bank institutions.

Definition of 'core deposits'

2.3 The Banking Reform Bill requires that all deposits with UK institutions are 'core deposits', apart from those exempted in secondary legislation. Article 3 of this Order ensures that the following five categories of deposits will not be core deposits:

- deposits of large organisations;
- deposits of individuals who have certified that they are high net worth and have made an active choice to deposit outside the ring-fence;
- deposits of individuals who are closely related to a high net worth individual and have made an active choice to deposit outside the ring-fence;
- non-EEA deposits; and
- deposits of financial institutions.

Large organisations

2.4 The ICB recommended that while retail deposits (deposits of individuals or SMEs) should always be ring-fenced, larger organisations should be permitted (but not required) to deposit with non-ring-fenced banks.[1] To implement this recommendation, article 3 provides that the deposits of large organisations are not core.

2.5 In line with the ICB's suggestion that the threshold for large organisations should follow definitions included in the Companies Act, the *Banking reform* white paper proposed an annual turnover threshold of between £6.5 million and £25.9 million.

2.6 The level of the threshold must be such as to guarantee the protection of the ring-fence to those organisations that need it, while at the same time allowing larger firms, which are likely to be better able to cope with a temporary interruption in services, to deposit with a non-ring-fenced bank if they wish to. Article 4 of the Order therefore defines a large organisation as an enterprise[2] that has:

- turnover greater than £6.5 million per annum;

[1] Understood in this chapter as meaning banks that are neither ring-fenced banks nor exempt small banks.

[2] 'Enterprise' is defined as per European Commission recommendation 2003/361/EC of 6 May 2003. This provides that, in deciding if an enterprise meets the criteria for a large enterprise, its partner and linked enterprises are included. So subsidiaries of large enterprises will likely be able to bank outside the ring-fence, provided their parent enterprise is a linked or partner enterprise.

- more than 50 employees; or
- an annual balance sheet total greater than £3.26 million.

The article also makes separate provisions for charities and public bodies of an equivalent size.

2.7 The *Banking reform* white paper proposed that the eligibility of a firm to bank outside the ring-fence should be based on turnover over a fixed period, to prevent a temporary fall in turnover resulting in a firm's deposits suddenly needing to be moved from a non-ring-fenced to a ring-fenced bank. It also proposed that when a firm does not meet the threshold for exemption for a prolonged period of time, the non-ring-fenced bank should examine the financial circumstances of the firm and move them inside the ring-fence where necessary. However, requiring banks to monitor the precise details of all their business customers' financial circumstances would be very burdensome, and there may be circumstances in which banks are unable to obtain the necessary information.

2.8 The Government has therefore opted instead for a self-certification regime for large organisations that wish to bank outside the ring-fence. The Order requires an organisation to declare that it meets at least one of the criteria listed above, in order to be able to place deposits with it. The declaration must be signed by the firm's accountant or auditors and must be renewed at least every 18 months. However, between renewal points its eligibility to deposit outside the ring-fence will not change, regardless of any fluctuations in its size.

2.9 This system of certification will ensure that organisations can only deposit outside the ring-fence as a result of an active choice to do so, and avoids requiring banks to monitor continually the details of their customers' turnover, workforce or balance sheet. It also removes the possibility that an organisation's eligibility to deposit outside the ring-fence could change frequently as a result of short-term fluctuations in its turnover, workforce size or balance sheet.

2.10 Article 8 sets out the steps that need to be taken when a depositor becomes, or is close to becoming, ineligible to bank outside the ring-fence. The Order requires that, if an organisation has not renewed its declaration after 12 months, the non-ring-fenced bank must notify it that its deposits will become core if no new declaration is made before the 18 month point. Unless a further declaration is received or the deposit is withdrawn, the non-ring-fenced bank will have six months from the date of the notice to transfer the deposits to a ring-fenced bank in its group (or another bank nominated by the customer) through the process set out in article 8.

Box 2.A: Consultation questions

1. Do you agree with the proposed definition of large organisations?
2. Do you agree with the proposed certification system for large organisations that wish to deposit outside the ring-fence?
3. Do you have any other views on the approach taken here?

High net worth individuals (HNWIs)

2.11 The ICB recommended that only sophisticated investors with substantial liquid wealth be allowed to deposit outside the ring-fence, as such individuals would be able to tolerate a temporary interruption in access to their accounts. The *Banking reform* white paper therefore suggested that to be eligible to bank outside the ring-fence, individuals should have to have 'free and investible assets' (that is, liquid financial assets, excluding the value of assets such as property and pension rights) with a single bank above a threshold set in the range of £250,000 to £750,000, and should have made an active choice to bank with a non-ring-fenced bank.

2.12 The Government continues to support this general approach, but now believes that total individual wealth is likely to be a better basis for this exemption than wealth with a single bank. The Order provides that HNWIs choosing to deposit outside the ring-fence must make a signed declaration that they wish to do so. The wording of the statement of eligibility for HNWIs wishing to deposit outside the ring-fence is provided in Part 1 of the Schedule to the Order. It includes a declaration that they wish to be able to deposit outside the ring-fence and that they have free and investible assets of £250,000 or more. The statement must be countersigned by a chartered accountant.

2.13 Article 3 of the Order sets out that a deposit is not a core deposit if one or more of the account holders is an eligible individual (that is, a HNWI who has signed a statement of eligibility). The effect of this is that deposits in joint accounts can be held outside the ring-fence as long as one of the account holders holds a certificate of eligibility.

2.14 The *Banking reform* white paper proposed that, when an individual does not meet the threshold for exemption for a prolonged period of time, the non-ring-fenced bank should examine the financial circumstances of the individual and move them inside the ring-fence where necessary. The Government, however, believes that a more appropriate mechanism is to require HNWIs to renew their statement of eligibility, reconfirming their eligibility and desire to bank outside the ring-fence, at least every 30 months. This will avoid a burdensome requirement for banks to examine in detail the financial circumstances of their customers, and will ensure that depositing with a non-ring-fenced bank remains the result of an active choice to do so.

2.15 Article 8 of the Order sets out the steps that must be taken if an individual ceases to be eligible to deposit outside the ring-fence because their statement of eligibility has expired. The Order requires that if an 'eligible individual' has not renewed their statement after 24 months, the non-ring-fenced bank must notify them that their deposits will become core if no new statement is received before the 30 month point. Unless a further statement is received or the deposit is withdrawn, the non-ring-fenced bank will have six months from the date of the notice to transfer the deposits to a ring-fenced bank in its group (or another bank nominated by the customer) through the process set out in article 8.

Family members of HNWIs

2.16 There is a case for permitting family members of high net worth individuals to deposit outside the ring-fence, provided that they make an active choice to do so. This is because, to the extent that they can rely on support from their HNW relatives, such individuals may be able to cope with a temporary interruption in access to their accounts.

2.17 The Order therefore provides that close relatives of HNWIs choosing to deposit outside the ring-fence may make a signed declaration that they wish to do so. The wording of this statement (a 'family member statement') is provided in Part 2 of the Schedule to the Order. It includes a declaration that they wish to deposit outside the ring-fence and that they are an 'eligible family member' of an 'eligible individual' (that is a HNWI who has certified that they wish to deposit outside the ring-fence). Only the partners, parents, children or step-children, or (if they are under the age of 18) partner's child or step-child of an eligible individual can be eligible family members. The family member statement must be signed both by the family member and by the eligible individual of whom the family member is a relative.[3] The related eligible individual's statement of eligibility must be attached to the family member statement.

[3] If the family member is under the age of 18, the family member statement must be signed on their behalf by a HNWI of whose family they are a member; in almost all cases this is likely to be the countersigning HNWI.

2.18 A family member statement will remain valid as long as the attached eligible individual's statement of eligibility is valid. Article 9 of the Order sets out the steps that must be taken if an individual ceases to be eligible to deposit outside the ring-fence because the statement of eligibility attached to their family member statement expires. The Order requires that if an eligible family member has not renewed their statement six months before the attached statement of eligibility has expired, the non-ring-fenced bank must notify them that their deposits will become core if no new statement is received before the attached statement expires. Unless a further statement is received or the deposit is withdrawn, the non-ring-fenced bank will have six months from the date of the notice to transfer the deposits to a ring-fenced bank in its group (or another bank nominated by the customer) through the process set out in Article 9. To renew their eligibility to bank outside the ring-fence, the family member must provide both a new family member statement and a new attached statement of eligibility.

2.19 The Government recognises that this certification process does place some additional burdens on both banks and depositors wishing to deposit outside the ring-fence. This is necessary, however, to ensure that only those who can count on the support of HNW relatives and who actively choose to do so may deposit outside the ring-fence.

Box 2.B: Consultation questions

4 Do you agree with the proposed threshold of £250,000?

5 Do you agree with the proposed method of certification for high net worth individuals?

6 Do you agree that family members of certified high net worth individuals should be able to bank outside the ring-fence? Do you have any views on the proposed method of certification for family members of high net worth individuals?

7 Do you have any other views on the approach taken here?

Geographic scope of 'core deposits'

2.20 The ICB recommended that UK retail deposits be mandated inside the ring-fence, and EEA deposits be permitted within the ring-fence. However, there is a real risk that this may give rise to issues regarding freedom of movement and discrimination under EU law. Accordingly, the draft Order provides that EEA deposits are core deposits in the same circumstances as UK deposits (that is, all EEA deposits are core deposits except for those of large organisations, certified HNWIs and financial institutions).

2.21 This will mean that EEA branches of UK banking groups that are required to ring-fence will be branches of those groups' ring-fenced banks, and will be subject to the restrictions of the ring-fence. Overseas subsidiaries (including EEA subsidiaries) are not incorporated under UK law, so are not subject to ring-fencing. EEA subsidiaries of UK banking groups that take retail deposits may therefore be subsidiaries of either those groups' ring-fenced or non-ring-fenced banks.

Financial Institutions

2.22 Ring-fenced banks will be prohibited from lending to financial institutions (see Chapter 3). In order to avoid the possibility that very small financial institutions are simultaneously required to deposit with ring-fenced banks but unable to borrow from them, the Order provides that the deposits of all financial institutions should not be core deposits. All financial institutions will thus be permitted (but not required) to deposit with non-ring-fenced banks. The definition of 'relevant financial institution' used in this Order (article 5) matches that used in article 2 of the Excluded Activities and Prohibitions Order.[4]

Box 2.C: Consultation question

8 Do you agree with this approach to financial institutions?

Institutions exempted from ring-fencing

2.23 The Banking Reform Bill requires all institutions that carry out core activities to ring-fence, unless exempted by secondary legislation. The only core activity currently defined under the Bill is accepting core deposits. Article 6 of the Order creates exemptions from ring-fencing for the following classes of institutions:

- small banks; and
- non-bank institutions.

De minimis exemption

2.24 In line with the *Banking reform* white paper and the recommendations of the PCBS, the Government proposes to create a *de minimis* exemption from ring-fencing for small banks. This will avoid small banks facing disproportionate costs as a result of ring-fencing, which could impede their ability to compete and grow, and could deter new banks from entering the market.

2.25 Article 6 of the Order therefore provides that banks whose 'core deposits' do not exceed £25 billion will not be ring-fenced bodies.[5] To avoid the status of banks depending on short-term fluctuations in their level of deposits, article 6 provides for total core deposits to be calculated for these purposes as a rolling average over a three year period. The Government estimates that with the threshold set at £25 billion of core deposits, around 90 per cent of UK retail deposits in UK institutions will be held in ring-fenced banks or building societies.

2.26 To prevent large banks from avoiding ring-fencing by splitting their deposits across multiple entities, each individually below the £25 billion threshold, article 7 provides that in calculating their total core deposits, groups must sum the core deposits held by each member of the group that is a UK institution.

Box 2.D: Consultation questions

9 Do you agree with the proposed *de minimis* exemption for small banks?

10 Do you agree with the proposed threshold of £25 billion of core deposits?

11 Do you have any other views on the approach taken here?

Other exempted institutions

2.27 The ICB designed ring-fencing to address problems specific to banks and banking services. It did not intend for ring-fencing to be applied to other financial institutions. Article 6 of the Order therefore exempts from ring-fencing insurance firms, who may have permission to accept

[4] See Chapter 3, paragraph 3.28.

[5] An absolute figure of £25 billion is preferred to a percentage of GDP because GDP statistics are subject to continual revision; there could therefore be no certainty about the monetary value of a threshold defined as a percentage of GDP.

deposits but for whom ring-fencing would not be appropriate. Article 6 also exempts credit unions and industrial and provident societies, whose activities are governed by separate legislation.

Box 2.E: Consultation questions

12 Do you agree that non-bank institutions should be exempted from ring-fencing?

13 Do you have any other views on the approach taken here?

3 Excluded activities and prohibitions

3.1 The Excluded Activities and Prohibitions Order is concerned with those activities that ring-fenced banks may not do. These fall into two broad categories: excluded activities and activities that are the subject of prohibitions. This chapter considers each in turn.

Excluded activities

3.2 Under the Banking Reform Bill, ring-fenced banks may not carry on excluded activities. The Bill creates one excluded activity – the regulated activity of dealing in investments as principal – and gives the Treasury the power to create additional excluded activities through secondary legislation. The Bill also gives the Treasury the power to create exemptions by specifying the circumstances in which ring-fenced banks may carry on an excluded activity. The following sections discuss first additional excluded activities, and then exemptions.

Additional excluded activities

3.3 In the *Banking reform* white paper, the Government committed to using the power to create additional excluded activities to ensure that investment banking activities that the ICB recommended ring-fenced banks should not be permitted to carry on, but which did not fall within the scope of dealing in investments as principal, be excluded from the ring-fence. This statutory instrument therefore provides that a further activity – commodities trading – is an excluded activity.

3.4 The Government believes that the addition of this further excluded activity will ensure that ring-fenced banks will be banned from all the trading activities the ICB recommended should be prohibited. It does not believe that any other activities need to be excluded at this stage.

Commodities trading

3.5 Trading in physical commodities such as metals, oil or agricultural commodities would expose ring-fenced banks to fluctuations in global market prices (as well as being incidental to the process of intermediation between borrowers and savers). Commodities trading would thus expose ring-fenced banks to the risks associated with volatile global market prices. Trading physical goods does not, however, come within the definition of dealing in investments as principal. Article 3 of the Order provides that trading in commodities (as defined in the Building Societies Act 1986) is an excluded activity.

Box 3.A: Consultation questions

14 Do you agree that commodities trading should be an excluded activity?

15 Do you agree with the Government's proposed definitions of this activity?

16 Do you have any other views on the approach taken here?

17 Do you think any further activities should be excluded?

Exemptions from excluded activities

3.6 The Order creates four exemptions from the excluded activity of dealing in investments as principal. These relate to:

- simple derivatives;
- securitisation of own assets;
- debt-equity swaps; and
- ancillary activities.

Simple derivatives

3.7 As proposed in the *Banking reform* white paper, and in line with the recommendations of the Parliamentary Commission on Banking Standards, the Government intends to permit ring-fenced banks to sell simple derivatives products to their customers, subject to safeguards. Article 6 of the Order sets out the types of product that ring-fenced banks may sell to its customers, and the safeguards that will apply to limit the riskiness and size of a ring-fenced bank's client derivatives portfolio. The following section and the restrictions outlined in it apply solely to derivatives supplied by a ring-fenced bank to its customers, rather than derivatives used by the ring-fenced bank to hedge its own balance sheet risks. A separate exemption for this is provided under article 4.

Product types

3.8 Article 6(2)(a) limits the derivatives which clients may obtain from ring-fenced banks to derivatives related to currencies, interest rates or commodities. The Government considers that this will allow UK businesses to hedge the most commonly encountered business risks, and recognises that risk management products can play an important part in the real economy.

3.9 To ensure that the derivatives portfolio does not pose an obstacle to the resolution of a ring-fenced bank, resolution authorities must be able to sort out a bank's derivatives portfolio in a timely manner in a resolution scenario. Article 6(2)(b) therefore limits the types of derivatives a ring-fenced bank can sell to products where the amount payable in relation to the derivative moves in direct proportion to the change in value of the risk factor it hedges (i.e. commodity prices, interest rates and foreign exchange rates). This would limit the product range that a ring-fenced bank can sell to forward, future and swap contracts.

3.10 As a further measure to support timely valuation of ring-fenced banks' derivatives portfolios in the event of resolution, article 6(2)(c) restricts the products a ring-fenced bank can sell to its customers to those that fall into levels 1 and 2 of the fair value hierarchy set out as part of the International Financial Reporting Standards ('IFRS 13'). This means that either the price of the product itself, or prices used to value the product are observable in the market. This restriction stops ring-fenced banks from selling products which hedge, for example, certain types of illiquid instruments, which are not commonly traded. Such derivatives may be challenging to value and so are likely to pose a risk to the orderly and timely winding down of a ring-fenced bank's derivatives portfolio during a resolution.

Limits on the risk and portfolio size

3.11 Limiting the range of derivatives ensures that the derivatives portfolio does not hinder ease of resolution. In order to ensure that a ring-fenced bank does not take excessive risks through its derivatives portfolio, article 6(3)(a) creates a cap on the market risk a ring-fenced bank exposes itself to through the sale of derivatives to clients. Market risk is the risk that the bank suffers losses due to changes in potentially volatile market prices, for example prices of securities, that are external to the bank. Exposure to market risk could endanger the safety of a bank, while being incidental to intermediation between savers and borrowers. The ICB therefore recommended that ring-fenced banks should not undertake activities which would expose them to market risk.

3.12 The net cap is designed to ensure that the net market risk (i.e. after hedging) that a ring-fenced bank can run as a result of the sale of derivatives is no more than a small portion of the total risk against which the bank must hold capital. Article 6(3)(a) provides that a ring-fenced bank's net position risk requirement in relation to the sale of derivatives to clients may not be more than 0.5 per cent of the bank's total own funds. This approach links the risk that a ring-fenced bank can take on through the sale of derivatives to a measure of the prudential soundness of a bank, ensuring that the sale of derivatives to clients does not create undue risks to the safety and soundness of a ring-fenced bank. This sets a clear direction for ring-fenced banks to hedge almost all the risks that result from the sale of derivatives to clients. This cap is very close to zero, but leaves some room for banks to leave some small amount of risk unhedged for operational purposes. It is economically efficient for banks to bundle risks resulting from various positions together and hedge this overall position in the interbank market. To gather together risks from different positions requires some risks to be temporarily unhedged. Setting the cap at zero would likely increase the costs of a hedge, which may feed through to an increase in the price consumers face to access risk management products. This cap has been set tightly enough for the resulting risks not to pose a danger to the ring-fenced bank.

3.13 The PCBS also called for an overall limit on the number of derivatives transactions a ring-fenced bank can enter into with its customers, on the basis that, even if hedged, a large derivatives portfolio could still pose an unacceptable risk to the stability and resolvability of the bank. The Government agrees – the Order therefore imposes a second, 'gross' cap on the total volume of derivatives ring-fenced banks may provide to their customers. This 'gross' cap does not take into account any hedging by the ring-fenced bank of derivatives positions with respect to customers, or any netting agreements covering multiple derivatives with the same client, which provide that in the event of a default, all the derivatives under the agreement can be collapsed into a single flow of payment between the bank and the client.

3.14 Setting the 'gross' cap involves deciding on both the cap's definition and its level. The Government considered limiting the total mark-to-market value of ring-fenced banks' derivatives portfolio. This value, however, is dependent on external market prices over which banks have no control; measured on this basis, the size of a bank's derivatives portfolio could vary relative to the limit purely as a result of external factors, not choices made by the bank. A more stable metric is a bank's capital requirement against the risk arising from its derivatives positions (its 'position risk requirement'). Restricting the position risk requirement relative to the bank's total capital requirement against the credit risk arising from extending loans links the bank's ability to sell derivatives to customers with its lending activity. This would mean that if the bank lent more or made riskier loans, increasing its credit risk capital requirement, the limit on its total derivatives portfolio would also increase.

3.15 Customers will often use derivatives products, in particular interest rate hedging products, to manage the risks associated with loans. The Government therefore believes that linking the amount of derivatives a ring-fenced bank may provide to its customers with its lending activity is appropriate. On the basis of initial modelling, the Government believes the cap should be set at 20 per cent of a ring-fenced bank's credit risk requirement (though this limit may be revised in the light of further data, should this become available). This level is likely to be such as to allow a broad ring-fenced bank to meet the demand for simple derivatives from its expected customer base. Article 6(3)(b) therefore provides that the total position risk requirement arising from the derivatives a ring-fenced bank provides to its customers may not exceed 20 per cent of the ring-fenced bank's total credit risk capital requirement.

3.16 The set of restrictions proposed here will limit both the range and the volume of products a ring-fenced bank can sell directly to its customers. However, ring-fenced banks will still be able to arrange the sale of more complex risk management products to those of its customers with more complex business needs on an arm's length basis, possibly through the non-ring-fenced bank. This will not expose the ring-fenced bank to the prudential risks associated with the sale of derivatives while affording customers of ring-fenced banks the flexibility necessary to manage different types of business risk.

Box 3.B: Consultation questions

18 Will allowing ring-fenced banks to sell derivatives hedging interest rate, foreign exchange and commodity risk enable small businesses to hedge the most common risks?

19 Do you agree that limiting derivatives to those classed as falling into levels 1 and 2 of the fair value hierarchy of IFRS 13 limits the sale to products that can be valued relatively easily?

20 What are your views on the restriction of contracts to forward, future and swap contracts only?

21 How do you think the sale of derivatives on a brokerage basis could be organised?

22 Do you think that the methods chosen for the net and gross caps are an adequate means of limiting the riskiness and the size of a ring-fenced bank's client derivatives portfolio respectively? Do you agree with the proposed limits?

23 Do you have any other views on the approach taken here?

Securitisation of own assets

3.17 The ICB recommended that ring-fenced banks should be permitted to securitise their own assets and to retain notes from such securitisations, subject to the appropriate capital requirements. To allow own asset securitisation requires exemptions both from the excluded activity of dealing in investments as principal (without which ring-fenced banks would not be permitted to transfer assets to a securitisation vehicle, or to retain any notes issued by a securitisation vehicle) and from the prohibition on exposures to financial institutions (without which ring-fenced banks would not be permitted to provide services such as liquidity facilities to their own securitisations). Article 4(5) of the Order therefore provides that a ring-fenced bank may transfer assets to securitisation companies, provided that the securitisation vehicles concerned only hold assets acquired from the ring-fenced bank. To permit ring-fenced banks to retain notes issued by such vehicles, and to provide liquidity and risk management facilities to their own securitisations, article 8(10) permits a ring-fenced bank to have exposures to securitisation companies, as long as those securitisation companies only hold assets acquired from the ring-fenced bank. In order to allow ring-fenced banks to realise the full funding benefits of securitising their own assets, article 8(12)(a) permits them to enter into repo transactions using any notes issued by their own securitisations that they hold, as well as with their other assets.

3.18 Some banks currently offer secured finance to corporate customers through conduit companies set up by the client to hold assets acquired from the client as security for the loan. These arrangements can be economically identical to secured loans to the client, the conduit serving only to make enforcement of the security for the loan simpler in the event of default. In order to avoid the distortion of discriminating between different forms of secured lending according to their legal form, article 8(11) permits a ring-fenced bank to have exposures to a conduit, provided that the conduit only exists in order to acquire assets from a single non-financial customer of the ring-fenced bank, and use these assets as security for a loan from the ring-fenced bank. The conduit must also be fully consolidated onto the balance sheet of the non-financial customer.

Debt-equity swaps

3.19 The ICB recommended that ring-fenced banks should be able to hold equity stakes in customer firms following a debt restructuring, for example through a debt-equity swap. This was to avoid limiting ring-fenced banks' options in the event of loans going bad, and thus disincentivising them from lending to business. Article 4(3) of the Order therefore provides that ring-fenced banks may acquire common equity shares from companies in exchange for releasing them from all or part of a debt. Article 4(4) then provides that ring-fenced banks may subsequently sell shares acquired through debt-equity swaps.

Box 3.C: Consultation questions

24 Do you agree with the exemption permitting ring-fenced banks to acquire shares in companies through debt-equity swaps?

25 Do you have any other views on the approach taken here?

Ancillary activities

3.20 The ICB recommended that ring-fenced banks should be permitted to trade in securities and enter into derivatives contracts for the purpose of managing the risks arising from their balance sheets (the ICB described these as 'ancillary activities' to ring-fenced banks' core business). The Government agrees that ring-fenced banks should not be prevented from prudently managing their own risks; the Order therefore creates exemptions for own-risk management.

3.21 Article 4(1) provides that ring-fenced banks may deal in investments as principal for the purpose of limiting their exposures to specified risks. These include interest rate, exchange rate and commodity price risk, the risk that borrowers will fail to repay their loans (or that the value of security pledged against those loans will fall), and the risk that a ring-fenced bank will not have sufficient liquid assets to meet its own obligations as they fall due. The exemption from the excluded activity of dealing in investments as principal is broadly matched by an exemption from the prohibition on exposures to other financial institutions, which is discussed below.

3.22 Restricting the exemption for own-risk management to these types of risk should allow ring-fenced banks scope to manage their own balance sheets prudently, and hedge against the risks arising from lending and the provision of simple derivatives products, without undermining the strength of the ring-fence. Banks' hedging activities are subject to strict supervisory control by the PRA, who will monitor the way this exemption is used by ring-fenced banks.

Structured products

3.23 The Government is aware that banks currently sell a variety of structured products, such as structured deposits and investments. With returns not simply linked to interest rates, these more complex products may require ring-fenced banks to hedge risks that are not provided for in the Order. The Government is concerned that such products may pose challenges in resolution, as they may be difficult to value. There is therefore a prudential case for preventing ring-fenced banks from offering these products, and the Government has yet to see compelling evidence for the necessity of creating an exemption for them.

Box 3.D: Consultation questions

26 Do you agree with the approach taken to banks' own-risk management?

27 Do you think that ring-fenced banks should be allowed to offer structured products? Which types of product do you think would be suitable?

28 Do you have any other views on the approach taken here?

Prohibitions

3.24 In addition to defining excluded activities, this statutory instrument also imposes specific prohibitions on ring-fenced banks. These prohibitions are on:

- exposures to financial institutions; and
- branches and subsidiaries outside the EEA.

Prohibition on exposures to financial institutions

3.25 The ICB recommended that ring-fenced banks be prohibited from having exposures to other financial institutions. This was to reduce ring-fenced banks' exposures to financial markets in which they themselves were not permitted to trade, and to prevent arbitrage of the ring-fence. The ICB also recommended, however, that ring-fenced banks be permitted to provide payments services to other financial institutions, to provide trade finance services, and to carry on 'ancillary activities' to manage their own risks and liquidity.

3.26 The following sections discuss:

- the definition of financial institutions; and
- exemptions from the prohibition.

Definition of financial institutions

3.27 Article 8 of the Order prohibits ring-fenced banks from having exposures to 'relevant financial institutions'. These are defined in article 2 as:

- banks other than ring-fenced banks;
- investment firms (except those not authorised to deal in investments as principal or as agent);
- insurers (including reinsurers and insurance holding companies);

- investment funds and fund management firms;
- securitisation companies; and
- financial holding companies.

3.28 The Government believes that prohibiting exposures to these groups of firms will help to insulate ring-fenced banks against financial market shocks. In line with the ICB's recommendations, this prohibition will apply only to the asset side of ring-fenced banks' balance sheets – ring-fenced banks will be permitted to raise funding from financial institutions. Also in line with the ICB's recommendations, article 8(3) of the Order provides that the prohibition on exposures to relevant financial institutions will not apply to intra-group exposures (other than short term exposures), which will be governed by rules made by the regulator.[1]

Small banks

3.29 Due to the proposed *de minimis* exemption from ring-fencing, no bank with core deposits of less than £25 billion will be a ring-fenced bank. Ring-fenced banks will therefore be prohibited from having exposures to small banks, even those with a purely or predominantly retail business model. This could be inconsistent, as ring-fenced banks will be able to have exposures to each other.

3.30 Prohibiting exposures to small banks would also deny small banks access to finance or services such as liquidity lines from ring-fenced banks. To the extent that small banks could not source alternative funding (or obtain other necessary services) from non-ring-fenced banks, this could hinder their ability to grow their businesses on the basis of diversified funding strategies. There may therefore be a case for permitting ring-fenced banks to have exposures to small banks, in order to support smaller banks and thus greater competition in the banking market.

3.31 A small banks exemption could, however, bring prudential risks, especially if it permitted ring-fenced banks to have exposures to small banks that carry on excluded activities such as trading in securities. Permitting indirect exposures to excluded activities would be contrary to the intention of the financial institutions prohibition, and would reduce the extent to which the ring-fence protects critical core services against shocks originating elsewhere in the financial system.

Small funds

3.32 The Government is aware that there is currently some uncertainty over whether future non-ring-fenced banks will be interested in serving small investment funds. Smaller funds may be unattractive to investment banks, due to the limited size of their activities, compared to the average size of customers of an investment bank. However, the Government believes that since even small investment funds will need services such as complicated derivative products, prime brokerage services and other trading services that ring-fenced banks will not be permitted to provide, small funds are more appropriately served by non-ring-fenced banks. The Government does not, therefore, intend to create an exemption from the definition of a financial institution for small funds.

[1] With the exception of short-term payments exposures – see below.

Box 3.E: Consultation questions

29 Do you agree with the prohibition on ring-fenced banks having exposures to financial institutions?

30 Do you agree with the Government's proposed definition of 'relevant financial institutions' for the purposes of this prohibition? Do you think that small investment funds should be exempted from this definition? If so, what size limit would you recommend?

31 Do you believe that the Government should create an exemption for small banks? If so, what steps could be taken to protect against the prudential and arbitrage risks this creates?

32 Do you have any other views on the approach taken here?

Exemptions from the prohibition on exposures to financial institutions

3.33 The following sections discuss exemptions to the prohibition on exposures to financial institution for:

- payments services;
- trade finance; and
- liquidity management.

Payments services

3.34 The ICB recommended that ring-fenced banks should be permitted to offer payments services to other financial institutions, for example acting as correspondent bank. The ICB also recommended, however, that the exposures involved should be restricted in both size and tenor to prevent ring-fenced banks using this exemption to offer long-term loans.

3.35 In line with this recommendation, article 8(4) creates an exemption for exposures to financial institutions that arise in the course of providing payments services ('short-term exposures'). The article sets limits on a ring-fenced bank's exposures for this purpose: exposures to an individual financial institution may not exceed 2 per cent of the ring-fenced bank's capital, and aggregate exposures to all financial institutions may not exceed 10 per cent of capital (the Government may revise these limits in the light of further data should that become available). No exposure may last for more than five working days. Article 8(5) to (7) permits ring-fenced banks to provide overdrafts to other financial institutions for the purposes of providing payments services, subject to the same limits on exposure size and tenor, and to have 'nostro' and 'vostro' accounts. The short-term and continually fluctuating nature of these exposures will require that, unlike other exposures, they must be monitored in real time. Article 9 of the Order requires the PRA to make the necessary rules to require real-time reporting of these exposures. To ensure that these requirements apply equally to all payments services exposures, article 8(3) provides that the exemption for intra-group exposures does not apply to short-term exposures. Intra-group payments exposures are subject to the same restrictions as payments exposures to financial institutions that are not members of a ring-fenced bank's own group. This is an exception to the general rule that intra-group exposures are to be governed by PRA rules rather than detailed restrictions set in legislation.

3.36 The ICB also recommended that where use of payments systems (such as CHAPS or Bacs) is critical to a ring-fenced bank's business, it should access that system either as a direct member or through another ring-fenced bank. With small banks exempted from ring-fencing under the proposed *de minimis* provision, the Government believes the latter option unnecessary. Article 7 of the Order therefore provides that ring-fenced banks must be direct participants in all the payments systems that they use, unless becoming a direct participant is either impossible or, due to an individual bank's limited usage of a system, disproportionately costly.

Box 3.F: Consultation questions

33 Do you agree with the proposed exemption for exposures arising from the provision of payments services?

34 Do you agree with the proposed limits on such exposures?

35 Do you agree with the proposal that ring-fenced banks should be direct participants in all payments systems that they use, unless this is impossible or disproportionately costly?

36 Do you have any other views on the approach taken here?

Trade finance

3.37 The ICB recommended that ring-fenced banks be permitted to offer trade finance services. The Government agrees that it is important that ring-fencing does not have a disproportionate negative impact on the ability of UK businesses to trade internationally, or on the UK's ability to attract international investment.

3.38 Some trade finance services will, however, involve exposures to other financial institutions. For example, if a UK bank confirms a letter of credit issued by a foreign bank on behalf of an overseas customer of a UK exporter, the UK bank will have an exposure to the foreign bank. This could breach the prohibition on ring-fenced banks having exposures to other financial institutions. Therefore, to allow ring-fenced banks to provide such services, the Order provides for an exemption to permit exposures arising from the provision of trade finance services where:

- the exposure is demonstrably related to a 'real economy' transaction (the supply of goods or services); and
- the amount of the exposure is specified *ex ante*.

3.39 For these purposes "trade finance services" mean the issue or confirmation of a documentary credit or a guarantee for the benefit of the ring-fenced bank's customers.

3.40 As a further safeguard, the Order limits a ring-fenced bank's trade finance-related exposures to an individual financial institution to 5 per cent of the ring-fenced bank's capital, and limits aggregate trade finance exposure to all financial institutions to 10 per cent of capital. These limits will allow ring-fenced banks to provide trade finance services on a similar scale to long-run historical trends.

Box 3.G: Consultation questions

37 Do you agree with the proposed exemption for exposures arising from the provision of trade finance?

38 Do you agree with the proposed conditions and limits on trade finance-related exposures?

39 Do you have any other views on the approach taken here?

Liquidity management

3.41 To ensure that they are always able to meet their obligations when they fall due, and to cope with unexpected redemptions, banks are required to maintain a buffer of cash and other liquid assets, such as high-quality sovereign debt. In order to demonstrate that these assets can be readily liquidated should they be needed, banks are required to turn over a proportion of their liquid asset buffers continually, either by buying and selling assets, or by engaging in repo and reverse repo transactions. The ICB recommended that ring-fenced banks should not be prohibited from engaging in activities that were ancillary to their main business, including the management of their own liquidity.

3.42 The Order therefore provides for exemptions to permit prudent liquidity management. Article 4(2) permits ring-fenced banks to buy, sell or hold securities eligible for their regulatory liquid asset buffers – predominantly UK gilts and other highly-rated sovereign bonds. Article 8(12) permits ring-fenced banks to enter into repo and reverse repo transactions with these specified liquid assets, for the purpose of managing their liquidity (in addition to being permitted to repo their own assets for funding purposes as noted at paragraph 3.18 above). Article 5 of the Order permits ring-fenced banks to enter into transactions with central banks, and wholly owned subsidiaries of central banks. Under article 8, ring-fenced banks will also be permitted to deposit cash with the central bank, but not to deposit with non-ring-fenced banks or investment firms, as this could expose them to the risks arising from excluded activities.

Box 3.H: Consultation questions

40 Do you agree with the proposed exemptions for liquidity management?

41 Do you agree with the proposed range of liquid assets that ring-fenced banks will be permitted to trade?

42 Do you agree with the proposed set of high-quality liquid assets that ring-fenced banks may buy, sell, repo or reverse repo in order to manage their liquidity?

43 Do you have any other views on the approach taken here?

Geographical restrictions

3.43 The ICB noted that cross-border activities can be a channel of contagion and can pose significant obstacles to the resolution of a UK ring-fenced bank. The ICB therefore recommended that ring-fenced banks be prohibited from providing services to customers outside the EEA. Within the EEA, the Directive on the reorganisation and winding-up of credit institutions[2] ensures that in the event of a failure, the failed institution will be subject only to the insolvency

[2] European Parliament and Council Directive 2001/24/EC, http://europa.eu/legislation_summaries/internal_market/single_market_services/financial_services_banking/l24008_en.htm

law of the country where it is incorporated, resulting in a single insolvency proceeding. It also provides for the recognition of reorganisation measures, such as resolution tools, taken in relation to a credit institution by a Member State. In line with the policy set out in the *Banking reform* white paper, article 10 of this Order prohibits ring-fenced banks from having subsidiaries carrying out financial activities which would be regulated in the UK outside the EEA. The Order allows ring-fenced banks to have subsidiaries, such as service companies, which do not carry on any activity which would be regulated in the UK, outside the EEA, subject to any requirements imposed by the regulator – for example to ensure the bank's resolvability.

3.44 Recognising the important role Jersey, Guernsey, and the Isle of Man play as part of the Sterling Zone, the UK Government proposes that ring-fenced banks should be allowed to maintain branches in the Crown Dependencies. Deposits from the Crown Dependencies play an important part in the funding mix and liquidity base of UK ring-fenced banks. As such, access of UK ring-fenced banks to the Crown Dependencies has positive consequences for UK financial stability. As branches of a UK bank, they will be subject to the jurisdiction of the UK resolution authorities, allowing measures to be taken in relation to them under the special resolution regime set out in the Banking Act 2009. Other than in the Crown Dependencies, ring-fenced banks will not be permitted to have any branches outside the EEA.

Box 3.I: Consultation questions

44 Do you agree with the prohibition on ring-fenced banks having branches outside the EEA?

45 Do you have any other views on the approach taken here?

4 Loss absorbency requirements

4.1 The Government has accepted the ICB's recommendation that banks should be required to hold sufficient loss-absorbing capacity (primary loss-absorbing capacity or PLAC) to ensure that they are more resilient to shocks and that, if they do fail, losses can be borne by their shareholders and unsecured creditors rather than falling on the taxpayer. The Banking Reform (Loss Absorbency Requirements) Order establishes the framework through which non-capital PLAC requirements (i.e. those PLAC requirements which relate to debt issued by banks that cannot form part of their regulatory capital) will be imposed by the regulator on systemic UK banks and building societies.

4.2 The requirements for different classes of institution set out in the Order reflect the ICB's PLAC recommendations. The ICB recommended a minimum requirement of 17 per cent of risk-weighted assets[1] (RWAs) for the largest banks. It also recommended that minimum PLAC requirements should be scaled according to firms' systemic importance. The ICB also recommended that PLAC levels be set higher than its recommended minima for individual banks, according to particular circumstances.

The international context

4.3 The international regulatory dialogue and development of best practice on creating a credible bail-in mechanism, including appropriate requirements for minimum quantities of loss-absorbing capacity, has been progressing since the ICB published its recommendations, and it continues to do so. While the minimum requirements in the Order reflect the ICB's recommendations, the Government will of course need to consider any modifications that may be appropriate as a result of developments on international standards or best practice in relation to enhancing banks' loss-absorbency.

4.4 In particular, as set out in the *Banking reform* white paper, the PLAC requirement policy must sit within the context of the European Commission's forthcoming 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. The European Parliament agreed their version of the RRD on 20 May,[2] and the Council of the European Union reached agreement on a general approach on 27 June 2013.[3] These proposals both include provision for a 'minimum eligible liabilities requirement' – which is conceptually similar to the ICB PLAC requirement. Both the Parliament and Council texts propose that this requirement be determined on the basis of certain criteria, including the need to ensure firms hold sufficient liabilities that can be bailed in to absorb losses and to ensure that capital can be

[1] For continuity with the ICB and previous Government publications, this chapter refers to 'risk-weighted assets'. The Order refers to 'risk-weighted exposures' as this is the term that is used in EU legislation on capital requirements. Regulatory capital held by UK firms to fulfil the European requirements will also count towards the PLAC requirement for UK firms. The terms are equivalent.

[2] The European Parliament report is available at: http://www.europarl.europa.eu/document/activities/cont/201306/20130605ATT67282/20130605ATT67282EN.pdf

[3] The Council statement is available at: http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/137627.pdf. The statement "called on the presidency to start negotiations with the European Parliament with the aim of adopting the directive... before the end of the year."

restored to meet minimum requirements and sustain market confidence.[4] The draft Order is intended to set the framework within which the regulator will exercise its discretion in applying a minimum eligible liabilities requirement to UK banks. Any criteria, minimum quantum or other requirements for PLAC set out in the Order are of course subject to modification if they are incompatible with the framework for loss absorbency in the final Directive. One of the benefits of setting out the framework for non-capital PLAC requirements in a Statutory Instrument is that it provides flexibility for Government to respond to such changes quickly.

Regulatory capital

4.5 The Government agreed with the ICB that large ring-fenced banks should be subject to an equity 'ring-fence' buffer – above and beyond the tougher new Basel III minimum standards – of up to 3 per cent of RWAs.[5] The appropriate channel for implementing this is the discretionary 'Systemic Risk Buffer', which is provided for in CRD IV,[6] to be transposed into UK legislation later this year.

4.6 Regulatory capital requirements are therefore not in the scope of the Banking Reform Bill – rather, it covers the incremental (non-capital) element of debt that can be bailed in. PLAC may, however, include instruments which qualify for regulatory capital. It may be the case that firms would choose to meet PLAC requirements in excess of regulatory capital requirements by issuing eligible bonded debt instruments (see paragraphs 4.10 to 4.13 for further details on eligibility). The Order requires the regulator to permit banks to meet some, or all, of their non-capital PLAC requirement (which is additional to their regulatory capital requirement) by holding extra regulatory capital if they wish to do so.

The draft Order

4.7 This Order regulates the way in which the regulator may set non-capital PLAC requirements on systemic UK banks and building societies, to effect implementation of the ICB's loss absorbency standards. The Order applies to the following 'relevant' bodies:

- UK corporate authorised persons that are members of a UK headquartered global systemically important bank (G-SIB) group;[7]
- ring-fenced bodies; and
- other UK-incorporated entities identified as domestic systemically important banks (D-SIBs)[8] by the regulator.

4.8 In setting such PLAC requirements, and subject to the specific conditions listed in the sections below for applying requirements to different classes of institution, the Order requires that the regulator must, so far as is reasonably practicable, take into account the degree of risk the failure of a relevant body is perceived to pose to:

- the continuity of the provision in the United Kingdom of core services; or
- the stability of the financial systems within the United Kingdom.

[4] See Article 39(3) of the European Parliament and Council texts. The Council's general approach also envisages that resolution authorities should not have recourse to national resolution financing arrangements until 8 per cent of a firm's total liabilities have been bailed in (see Article 38(3)).

[5] See the June 2012 white paper *Banking reform: delivering stability and supporting a sustainable economy*, Chapter 3. Note the Government accepted that there may be a case for applying a scaled-down equity buffer to smaller ring-fenced banks or other significant deposit-takers.

[6] Directive 2013/36/EU of 26 June 2013 on access to credit institutions and the prudential supervision of credit institutions and investment firms (OJ L 376, p.338, 27.6.2013), http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:176:0338:0436:EN:PDF

[7] This relates to the ICB recommendation that PLAC requirements should be calibrated to include RWAs in both UK and non-UK operations of UK headquartered G-SIBs.

[8] This category of relevant bodies includes building societies, and is referred to in the Order as domestic systemically important institutions, or D-SIIs.

4.9 This should create a presumption that, all else being equal, the highest requirements will be applied to the most systemic banks. The regulator must also ensure its decisions are consistent with the ongoing responsibilities of UK authorities in relation to the consolidated group supervision of UK-based cross-border banks.[9]

PLAC composition

4.10 The Government believes that PLAC should comprise the highest quality loss-absorbing instruments – that is capital (equity, Additional Tier 1 (AT1) capital, Tier 2 (T2) capital) and long-term unsecured debt that is clearly identified as subject to the anticipated future bail-in power, in line with the ICB's recommendation.

4.11 The Order implements this recommendation by defining eligibility criteria for debt instruments which may count towards PLAC. To be considered eligible, instruments must at a minimum have a remaining term of at least 12 months, and must meet any mandatory additional eligibility requirements that may come through the RRD. There may be a case for adding further criteria, for example a requirement that eligible instruments must be subordinated to other senior unsecured liabilities, or that they be issued from a holding company rather than an operational entity. The Government welcomes views on whether criteria such as these should be mandatory in all cases, or whether authorities should have discretion to apply them on a case-by-case basis (for example, in the context of each individual firm's resolution strategy or business model).

4.12 As explained above, the Order does not apply to requirements relating to debt which qualifies as regulatory capital (i.e. AT1 or T2).

4.13 The Order requires the regulator to permit banks to meet some, or all, of their debt requirement (beyond their minimum regulatory capital requirement) by holding extra regulatory capital if they wish to do so. The Order does not prescribe how quickly an institution must replenish its PLAC requirement following resolution – that would be a matter for the regulator to determine.

PLAC requirements

UK headquartered G-SIBs

4.14 The Government agreed with the ICB that the largest UK headquartered G-SIBs should be subject to a minimum PLAC requirement[10] and that the setting of this requirement should be scaled according to individual firms' systemic importance. This would avoid creating an undesirable 'cliff' as a firm crosses the threshold into (or out of) G-SIB classification, and also ensure there is an inbuilt disincentive for G-SIBs to become increasingly more systemic once they have crossed the threshold.

4.15 The Order implements these recommendations by requiring that the regulator calibrate non-capital PLAC requirements on a sliding scale alongside the G-SIB equity surcharge proposed by the Basel Committee and Financial Stability Board (FSB) methodology.[11] Reflecting the

[9] Under EU law (CRDIV Article 131(3)(b)) and international agreements (FSB Key Attributes) the regulator must have regard to the risk posed by international banks to the stability of financial systems in the EU and globally.

[10] If one or more ring-fenced banks are members of a UK headquartered G-SIB, they must meet the separate ring-fenced bank PLAC requirements, as set out in the next section.

[11] See *Global systemically important banks: assessment methodology and the additional loss absorbency requirement*, Basel Committee (November 2011), http://www.bis.org/publ/bcbs207.pdf; and *Update of group of global systemically important banks (G-SIBs)*, Financial Stability Board (November 2012), http://www.financialstabilityboard.org/publications/r_121031ac.pdf. The FSB allocates those banks they identify as G-SIBs (in line with the *Global systemically important banks: assessment methodology and the additional loss absorbency requirement* report) into five equity surcharge buckets defined in the Basel Committee's guidelines.

recommendation in the ICB's report, the requirements imposed on a G-SIB in the top 2.5 per cent equity surcharge 'bucket' under the Order will therefore ensure that the G-SIB has PLAC of at least 17 per cent of its risk-weighted assets (subject to compatibility with future international standards and best practice).

4.16 The Government believes that it would be inappropriate for the regulator to include overseas operations of UK headquartered G-SIBs in the group PLAC calculation, where these operations do not pose a risk to UK, or EEA, financial stability. Accordingly, the regulator is required to include UK and EEA members of a banking group in the calculation of the non-capital PLAC required as a general rule. It is also required to include non-EEA subsidiaries in this calculation where the 'resolution strategy' (to be prepared for that G-SIB by the Bank of England) recommends that they be taken into account.

4.17 Where the resolution strategy envisages that a bank's overseas subsidiaries would be resolved locally by the host regulators and without reliance on the UK parent (a 'regional' resolution strategy), the parent company should not be subject to a requirement by the UK authorities to issue non-capital PLAC against those overseas subsidiaries. Overseas subsidiaries (of UK G-SIBs) that hold capital and bail-inable debt locally, and that more generally manage their relationships with other subsidiaries in the group and with their parent entity on an arm's length basis so that they can be separated from the group in resolution, are more likely to be suitable candidates for a regional resolution strategy (should they enact the necessary changes to make this viable) than those that are part of a more centralised group structure.

4.18 If, however, the resolution strategy envisages a 'whole group' solution – where the UK parent company might be required or expected to provide financial support to resolve failing overseas operations – the regulator will be required to ensure that the parent company issues non-capital PLAC against the entire group.

4.19 This principled basis for decisions on whether to apply non-capital PLAC at the group level should ensure there is clarity about where responsibility lies for resolving overseas subsidiaries.

Ring-fenced banks and other D-SIBs (including building societies)

4.20 In the *Banking reform* white paper, the Government agreed with the ICB that the largest UK ring-fenced banks should be subject to a PLAC requirement of at least 17 per cent of RWAs. The Government also took the view in the white paper that decisions on the scaling mechanism for equity and for PLAC should be taken once the Basel Committee had concluded its work on D-SIBs.

4.21 The D-SIB framework has now been published, and includes some specific criteria for identifying, and determining loss-absorbency requirements for, D-SIBs.[12] The Order requires the regulator to apply these criteria both to identify *additional* D-SIBs (it is assumed ring-fenced banks would themselves be D-SIBs) and to then calibrate minimum non-capital PLAC requirements for ring-fenced banks and D-SIBs ("D-SIB" includes both systemic banks and building societies, and accordingly the term used in the Order is "D-SII", or "domestic systemically important institution". The terms "D-SIB" and "D-SII" have the same meaning for the purposes of this consultation document) – although the regulator may also consider other

[12] National authorities should assess the degree to which banks are systemically important in a domestic context considering the impact of a D-SIB's failure on the domestic economy while having regard to the following factors: i) size; ii) interconnectedness; iii) substitutability/financial institution infrastructure (including considerations related to the concentrated nature of the banking sector); and iv) complexity (including the additional complexities from cross-border activity). In addition, national authorities can consider other measures/data that would inform these bank-specific indicators within each of the above factors, such as size of the domestic economy.

criteria when calibrating non-capital PLAC.[13] It provides for the regulator to set minimum requirements of at least 17 per cent for those ring-fenced banks and other D-SIIs it deems to be of greatest systemic importance to the UK and for non-capital PLAC requirements to be scaled according to systemic importance as discussed above.

4.22 This calibration approach has two key benefits. First, it will help to ensure that the methodology takes on board international best practice in setting loss-absorbency requirements, and that it is consistent with internationally agreed standards.

4.23 Second, it introduces a scaling mechanism that both accords with the ICB's recommendations and is operable in a context of there being an exemption from ring-fencing requirements for banks that hold less than £25 billion of core deposits (the Government takes the view that the costs of ring-fencing for these firms would be disproportionate to the benefits).

4.24 This means that, where institutions do not qualify as ring-fenced banks but are, for example, still significant providers of critical services, provision is made for them also to be subject to non-capital PLAC requirements. This should in turn serve to avoid possible 'cliff' effects for banks that are approaching, or cross, the *de minimis* threshold. It will also give the regulator appropriate discretion to differentiate between ring-fenced banks (and building societies) of different sizes and levels of systemic risk.[14]

4.25 To ensure that the ICB's loss-absorbency principles are implemented in a way that captures these benefits, the Order requires that the regulator take into account the following additional factors when setting these PLAC requirements on ring-fenced bodies and D-SIIs:

- quantum of core deposits – the larger the quantity of core deposits on an institution's balance sheet, the more systemic a provider of critical services it is likely to be; and
- aggregate of the amounts shown as assets on the balance sheet for the preceding financial year – the larger the amount, the more systemic the institution is likely to be. This requirement will serve to reinforce the onus on the regulator to differentiate, for example, between an institution that is of relatively significant size compared to the UK economy versus one that is relatively small, even if both hold a similar quantum of core deposits.

4.26 For any entity which is a subsidiary of a banking group which has its headquarters outside the UK, the regulator may also take into account whether sufficient PLAC requirements have been imposed by the group's consolidated group supervisor.

4.27 Furthermore, the Order permits the regulator to impose a ring-fenced entity's or D-SII's non-capital PLAC requirements (calibrated as above) on a *parent undertaking* of the entity, provided that the parent undertaking downstreams the relevant amount to the entity in an appropriate form.

Setting additional PLAC requirements

4.28 The Government agreed with the ICB that it may be appropriate to set PLAC requirements higher than the minimum levels it recommended (what the ICB called a 'resolution buffer'),

[13] Note that these listed criteria are not intended to be exhaustive – the regulator is not prevented from taking into account other factors it deems relevant.

[14] For example, the ICB recommended in its final report that PLAC requirements should be scaled up to 17 per cent for ring-fenced banks as their RWA-to-GDP ratios increased up to 3 per cent.

where concerns remain about a bank's resolvability. Following this principle that higher loss-absorbency requirements may be appropriate to ensure that firms can be made resolvable, the Order provides for the regulator to set additional non-capital PLAC requirements. Assessments should be carried out and higher requirements of such PLAC applied, where necessary, on a firm-by-firm basis. The Order requires the regulator to take account of the firm's resolution strategy prepared by the Bank of England (including any recommendations for higher non-capital PLAC requirements) when exercising its discretion on PLAC requirements. It may set an additional amount on any relevant body where the resolution strategy for that body recommends this to be appropriate.

Process

4.29 The regulator must consult HM Treasury before imposing non-capital PLAC requirements on any relevant body within the scope of the Order. It is also required to review the debt requirement for each relevant body whenever the resolution strategy for that body is changed, and in any event at least once a year.

Box 4.A: Consultation questions

46 Should there be any additional eligibility criteria for debt instruments that can count towards a firm's PLAC requirement beyond those included in the draft Order?

47 Are there any additional factors that should be included in the calibration mechanism for G-SIBs and/or ring-fenced banks and D-SIBs?

48 Do you have any other views on the approach taken here?

5 Fees and prescribed international organisations

5.1 Since the financial crisis, the Financial Stability Board (FSB) and other international bodies responsible for setting global financial standards and promoting financial stability have grown in importance. It is vital that the UK is adequately represented in these international fora, and appropriate that the costs of such representation are borne by its chief beneficiaries – the financial services industry itself. These costs would otherwise have to be met from taxpayer funds. Levies to cover the costs of the FCA's international activities are already imposed by the FCA on the regulated financial services community, and it is appropriate that HM Treasury should similarly be able to recover such costs from the industry.

5.2 Clause 13 of the Banking Reform Bill amends FSMA to allow HM Treasury to direct the regulators (the PRA, the FCA and the Bank of England) to charge financial services firms fees to reimburse HM Treasury for certain expenses incurred in connection with UK membership of, or Treasury participation in, international organisations with functions which relate to financial stability or financial services.

5.3 The scope of the work of such international fora may change over time – for example, as a result of international discussions on financial reform, or in response to innovation in the financial sector. This power has therefore specifically been designed to have sufficient flexibility to respond to such future changes.

5.4 The structure of the power is set out on the face of the Bill, but much of the detail – such as the list of international organisations for which HM Treasury expenses may be claimed, and the types of expenses that can be recovered under the power – is set out in the draft Fees and Prescribed International Organisations Regulations which will be made under clause 13 of the Bill. The requirements with which HM Treasury must comply before giving a direction to the regulators are also specified in the draft Regulations.

5.5 Regulations under clause 13 which only specify international organisations for which the Treasury may recover fees are subject to the negative resolution procedure. In all other cases, regulations made under clause 13 are subject to the draft affirmative resolution procedure. Applying the negative resolution procedure to regulations that only specify international organisations means that an organisation that needs to be specified only for technical reasons – for example a change of name or legal constitution – can be specified without necessitating a Parliamentary debate. For instance, in April 2009 the Financial Stability Forum changed its name to the Financial Stability Board to reflect its shifting role in international financial issues. HM Treasury Ministers will notify Parliament through a Written Ministerial Statement if and when any new international organisations are prescribed.

The draft Regulations

5.6 The draft Regulations provide that the Treasury may direct the relevant regulator (the PRA, the FCA or the Bank of England) to impose fees on PRA authorised persons, FCA authorised persons, recognised investment exchanges, and recognised clearing houses. These fees are to meet HM Treasury expenses incurred as a result of UK membership of, or HM Treasury participation in, international organisations concerned with financial stability or financial services. The expenses recoverable under this power are those which relate to a function of the relevant international organisation which concerns financial services or financial stability.

5.7 The draft Regulations also set out the factors that HM Treasury must consider before issuing a fees direction to the regulator: specifically, whether the fees to be charged to the industry via the regulator are affordable. In considering whether the fees are affordable, HM Treasury must take into account the views of the regulator and consider the affordability of the direction for the class of persons to whom it applies (or is likely to apply). If, for example, the regulator informs HM Treasury that imposing the charges on a class of persons at a given time is likely to increase concerns around financial stability more widely in the economy, HM Treasury will have to consider whether to charge a different level of fees, or charge them against a different class of regulated persons. In practice, however, HM Treasury anticipates that the level of fees will be minimal, and that they will be applied evenly across the regulated community.

5.8 Where the fees are to be collected by the FCA or the PRA, the relevant regulator must make rules providing for the charging of fees. When a regulator (including the Bank of England) has collected fees, it must pay the amount to HM Treasury by the time or times specified by HM Treasury in a direction. The regulators already have a cycle for collecting levies to meet their own expenses, and the draft Regulations provide sufficient flexibility to ensure they operate compatibly with that existing cycle, if that is the most efficient approach.

List of prescribed international organisations

5.9 At the outset, the Regulations only prescribe the Financial Stability Board as a relevant international organisation for which a fees direction may be issued. If in future HM Treasury wishes to reclaim the costs of participation in a new organisation, it will amend the Regulations to prescribe the new organisation and, if necessary, allow for its start-up expenses to be charged. It will then issue directions to the relevant regulator obliging it to require the payment of fees by the industry to meet such expenses.

Expenses recoverable under the Regulations

5.10 The draft Regulations also specify the kinds of expenses that can be recharged to the industry. This includes subscription costs or membership fees and capital contributions to the funding of an organisation, such as a payment into an endowment intended to fund the organisation.

Box 5.A: Consultation question

49 Do you have any views on the content of the draft Fees and Prescribed International Organisations Regulations?

A Ring-fenced Bodies and Core Activities Order

Draft Order laid before Parliament under section 142Z of the Financial Services and Markets Act 2000, for approval by resolution of each House of Parliament.

D R A F T   S T A T U T O R Y   I N S T R U M E N T S

201* No. XX

FINANCIAL SERVICES AND MARKETS

Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 201*

Made - - - -	***
Coming into force - -	***

The Treasury, in exercise of the powers conferred by sections 142A(2)(b), 142B(2), 142F and 428(3) of the Financial Services and Markets Act 2000 (**a**), make the following Order.

In accordance with section 142Z of the Financial Services and Markets Act 2000, a draft of this Order has been laid before Parliament and approved by a resolution of each House.

Citation and commencement

1. This order may be cited as the Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 201* and comes into force on [ ].

Interpretation

2.—(1) In this order—

"the Act" means the Financial Services and Markets Act 2000;

"alternative investment fund" has the meaning given in Article 4(1) of the directive of the European Parliament and of the Council of 8 June 2011 on alternative investment fund managers(**b**);

"balance sheet total" means the aggregate of the amounts shown on an enterprise's balance sheet;

"building society" has the meaning given in section 5 of the Building Societies Act 1986(**c**);

"charity" means a body as defined in section 1 of the Charities Act 2011(**d**) or section 1 of the Charities (Northern Ireland) Act 2008(**e**);

(**a**) 2000 c. 8. Sections 142A to 142O were inserted into the Act by the Financial Services (Banking Reform) Act 201*, section 4.
(**b**) OJ L174 1.7.2011, p.1.
(**c**) 1986 c. 53. Section 5 has been amended by the Building Societies Act 1997 (c. 32), sections 1 and 3, the Building Societies (Funding) and Mutual Societies (Transfer) Act 2007 (c. 26) section 1, and S.I. 2013/496.
(**d**) 2011 c. 25.
(**e**) 2008 c. 12.

“charitable incorporated organisation” means a body constituted and registered as a charitable incorporated organisation under Part 11 of the Charities Act 2011 or Part 11 of the Charities (Northern Ireland) Act 2008;

“commission recommendation” means recommendation 2003/361/EC of the European Commission of the 6 May 2003 concerning the definition of micro, small and medium-sized enterprises(**a**);

“core deposit” has the meaning given in article 3(2);

“credit institution” has the meaning given in Article 4.1(1) of the prudential requirements regulation;

“credit institutions directive” means the Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC(**b**);

“credit union” means a society registered as a credit union under the Industrial and Provident Societies Act 1965(**c**) or the Credit Unions (Northern Ireland) Order 1985(**d**);

“deposit” has the meaning given in article 5 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001(**e**);

“EEA account” has the meaning given in article 3(3)(b);

“eligible family member” means an individual who has provided a family member statement;

“eligible individual” means an individual whohas provided a statement of eligibility that is not more than thirty months old;

“enterprise” has the meaning given in Article 1 of the commission recommendation;

“exempt institution” means a UK institution which carries on the regulated activity of accepting deposits in accordance with a permission under Part 4A of the Act and which is exempt from the definition of a “ring-fenced body” under article 6(1) of this Order;

“family member statement” means a statement in the form set out in Part 2 of schedule 1 and signed—

(a) if the individual to whom it relates has not attained the age of 18, by an eligible individual of whose family they are a member,

(b) in all other cases, by the individual to whom the statement relates;

“financial holding company” has the meaning given in Article 4.1(20) of the prudential requirements regulation;

“industrial and provident society” means a society registered or deemed to be registered under the Industrial and Provident Societies Act 1965(**f**) or the Industrial and Provident Societies Act (Northern Ireland) 1969(**g**);

“insurance holding company” means a parent undertaking which—

(a) is not a mixed financial holding company, and

(b) the main business of which is to acquire and hold participations in subsidiary undertakings, where—

  (i) those subsidiary undertakings are exclusively or mainly insurance or reinsurance undertakings, or third-country insurance undertakings or third-country reinsurance undertakings, and

(**a**) OJ L 124, 20.5.2003, p. 36.
(**b**) OJ L 174 27.6.2013, p 338.
(**c**) 1965 c. 12.
(**d**) S.I. 1985/1205.
(**e**) S.I. 2001/544.
(**f**) 1965 c.12.
(**g**) 1969 c.24.

(ii) at least one of such subsidiary undertakings is an insurance or reinsurance undertaking;

"insurance undertaking" means an undertaking which has received authorisation as an insurance undertaking in accordance with the first non-life directive or the life assurance consolidation directive;

"management company" has the meaning given in Article 2(1)(b) of the UCITS Directive;

"mixed financial holding company" has the meaning given in Article 2(15) of Directive 2002/78/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate(**a**) (disregarding any decision taken under Article 3(3) of that Directive);

"prudential requirements regulation" means Regulation 575/2013/EU of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms(**b**);

"public body" means any person certain of whose functions are functions of a public nature;

"relevant financial period" means, in relation to an institution, the most recent period of three consecutive financial years for that institution;

"relevant financial institution" has the meaning given in article 5;

"relevant quarter" has the meaning given in article 6(3);

"reinsurance undertaking" means an undertaking which has received authorisation in accordance with Article 3 of the reinsurance directive;

"securitisation company" has the meaning given in section 623 of the Corporation Tax Act 2010(**c**);

"statement of eligibility" means a statement in the form set out in Part 1 of Schedule 1 and signed by the individual to whom it relates and a chartered accountant;

"third country insurance undertaking" means an undertaking which would require authorisation in accordance with the first non-life directive or the life assurance consolidation directive if it had its head office in the EEA;

"third country reinsurance undertaking" means an undertaking which would require authorisation in accordance with the reinsurance directive if it had its head office in the EEA;

"transfer date" means the first business day which falls not less than 6 months after the date on which a notice is sent by a UK institution under article 8(1) or 9(1).

"UCITS" has the meaning given in Article 1.2 of the UCITS Directive;

"UCITS Directive" means directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the co-ordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities(**d**); and

"voluntary organisation" means an organisation—

(i) which is not a public body;

(ii) which is not a charity or a CIO, and

(iii) whose activities are not carried on for profit.

(**a**) OJ L35, 11.02.2003, p.1.
(**b**) OJ L 176, 27.6.2013, p 1.
(**c**) 2010 c.4.
(**d**) OJ L302 17.11.2009, p. 32.

Circumstances in which accepting a deposit is not a core activity

3.—(1) In relation to a UK institution which carries on the regulated activity of accepting deposits in relation to which it has a permission under Part 4A of the Act, accepting a deposit is not a core activity if the deposit is not a core deposit.

(2) A deposit is a core deposit if it is held with the institution in an EEA account unless one or more of the account holders is—

(a) an eligible individual;

(b) an eligible family member;

(c) a large organisation, or

(d) a relevant financial institution.

(3) In this article—

(a) a reference to an account held with an institution is to an account provided by the institution as part of its activity of accepting deposits; and

(b) an account is a EEA account if it was opened at a branch located in an EEA member state.

Meaning of large organisation

4.—(1) For the purposes of this Order, in relation to any particular time, an organisation is a large organisation if—

(a) it has provided a statement signed on its behalf and by a chartered accountant or its auditors confirming that it meets the relevant criteria set out in paragraph (2), and

(b) that statement is not more than eighteen months old at that time.

(2) The criteria referred to in paragraph (1) are—

(a) in relation to an enterprise which is not a charity, charitable incorporated organisation (CIO), voluntary organisation or public body that it—

(i) employs more than 50 staff,

(ii) has a turnover of more than £6.5 million, or

(iii) an annual balance sheet total of more than £3.26 million, and

(b) in relation to an organisation which is a charity, CIO, voluntary organisation or public body, that it has a gross income of more than £6.5 million.

(3) For the purpose of paragraph (2)—

(a) the staff headcount and financial amounts specified in paragraph (2)(a) are to be calculated in accordance with articles 3 to 6 of the commission recommendation, and

(b) the gross income of a charity or a CIO which is a member of a group as defined in section 141 of the Charities Act 2011 will be deemed to include the gross income of any charity or CIO which is a member of the same group.

Relevant financial institution

5.—(1) For the purposes of this Order, a "relevant financial institution" means an institution which falls within one of the classes described in paragraph (2), and which is not within one of the exceptions set out in paragraph (3).

(2) The classes of relevant financial institutions are:

(a) credit institutions;

(b) investment firms;

(c) securitisation companies;

(d) insurance undertakings, insurance holding companies, third country insurance undertakings, reinsurance undertakings and third country reinsurance undertakings;

(e) UCITS (wherever established), alternative investment funds, or other form of collective investment scheme;

(f) management companies or alternative investment fund managers, and

(g) financial holding companies and mixed financial holding companies.

(3) The exceptions are—

(a) ring-fenced bodies;

(b) building societies;

(c) bodies corporate—

(i) whose purpose, or principal purpose, is that of making loans which are secured on residential property and which are funded substantially by their members, and

(ii) which are incorporated under the law of an EEA state other than the United Kingdom;

(d) those institutions referred to in Article 2.5 of the credit institutions directive; and

(e) investment firms who are not authorised to carry on by way of business (in the UK or the EEA) the activities specified by either article 14 (dealing in investments as principal) or article 21 (dealing with investments as agent) of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001(**a**).

Classes of institution that are not ring-fenced bodies

6.—(1) The following classes of institution are not ring-fenced bodies for the purposes of section 142A of the Act—

(a) subject to article 7, a UK institution which carries on the regulated activity of accepting deposits in accordance with a permission under Part 4A of the Act and which—

(i) in the case of a UK institution that has existed for three financial years or more, holds total core deposits the average value of which over a relevant financial period is equal to or less than £25 billion, or

(ii) in the case of any other UK institution, holds total core deposits the average value of which over the period for which the institution has existed is equal to or less than £25 billion;

(b) a UK institution which carries out the regulated activity of effecting or carrying out contracts of insurance as principal in accordance with a permission under Part 4A of the Act; or

(c) a credit union or an industrial and provident society.

(2) For the purposes of paragraph (1)(a) of this article the average value is determined as follows—

(a) for UK institutions falling within paragraph 1(a)(i)—

(i) calculate the total core deposits held by the UK institution at the end of each quarter in the relevant financial period to produce quarterly totals, and

(ii) add these quarterly totals together and divide by twelve, and

(b) for UK institutions falling within paragraph 1(a)(ii)—

(i) calculate the total core deposits held by the UK institution at the end of each relevant quarter, and

(ii) add these quarterly totals together and divide by the number of relevant quarters.

(3) For the purposes of this article "relevant quarter" means, in relation to an institution, any complete quarter following the date of incorporation of that institution.

(**a**) S.I. 2001/544. Article 14 was amended by S.I. 2006/3384. Article 21 was amended by S.I. 2003/1476; 2006/3384.

Determination whether UK institutions forming part of a group of companies are ring-fenced bodies

7.—(1) This article sets out the circumstances in which a UK institution which is part of a group of companies will be a ring-fenced body even if it falls within article 6(1).

(2) If a UK institution which holds core deposits is a member of a group of companies it will be a ring-fenced body unless the condition specified in paragraph (3) is met.

(3) The condition is that the sum of the core deposits held by members of the group which are UK institutions is less than £25 billion.

(4) The sum of core deposits held in a group shall be the sum of the average core deposits of each member of that group calculated in accordance with article 6(2).

Actions to be taken when deposits become core deposits: eligible individuals and large organisations

8.—(1) A UK institution that meets the conditions set out in paragraph (2) of this article must provide the notice referred to in paragraph (3) to its account holder if—

(a) the institution has previously received from the account holder a statement of eligibility or a statement complying with article 4(1)(a), and

(b) that statement is—

(i) in the case of a statement of eligibility, more than twenty four months old; or

(ii) in the case of a statement complying with article 4(1)(a), more than twelve months old,

but the statement has not been replaced by a more recent statement.

(2) The conditions referred to in paragraph (1) of this article are that the UK institution—

(a) carries out the regulated activity of accepting deposits in accordance with a permission under Part 4A of the Act, and

(b) is not a ring-fenced body for the purposes of section 142A of the Act, an exempt institution or a building society.

(3) The notice required under paragraph (1) must contain—

(a) a statement that if the account holder does not provide to the institution a further statement of eligibility, or a statement complying with article 4(1)(a) then the account-holder's deposits will become core deposits—

(i) in the case of an eligible individual, within thirty months following the date of the previous statement of eligibility for that individual;

(ii) in the case of a large organisation, within eighteen months following the date of the previous statement complying with article 4(1)(a) for that organisation;

(b) a statement that if the account-holder's deposits become core deposits they must be held in a ring-fenced body, an exempt institution (other than a body falling within article 6(1)(b)) or a building society;

(c) a request that the account holder responds in writing by the transfer date—

(i) providing to the institution a further statement of eligibility or statement complying with article 4(1)(a),

(ii) nominating a ring-fenced body to which the relevant deposits will be transferred if they become core deposits, or

(iii) confirming that they will accept repayment of the full amount of the deposits and providing the details of the account to which such repayment should be made or of an address to which payment could be sent;

(d) a statement that if the account holder fails to respond in writing before the date on which the deposits become core deposits they will be transferred to a ring-fenced body, and identifying the body to which the deposits will be transferred; and

(e) such other information as may be specified by the PRA or the FCA in rules from time to time.

(4) Where the UK institution is a member of a group which contains one or more ring-fenced bodies, the ring-fenced body identified under paragraph (3)(d) must be a member of the same group.

(5) If by the transfer date the account holder has not provided a further statement of eligibility or statement complying with article 4(1)(a), on the day immediately following the transfer date the institution must—

(a) transfer the relevant deposits to the ring-fenced body nominated by the account holder in accordance with paragraph (3)(c)(ii) of this article,

(b) repay to the account holder the full amount of the relevant deposits by electronic payment to an account notified by the account-holder or by sending payment to an address notified by the account holder, or

(c) if the account holder has failed to respond in writing by the transfer date, transfer the relevant deposits to the ring-fenced body specified in the statement given to the account holder under paragraph (3)(d) of this article.

Family members: actions to be taken when deposits become core deposits

9.—(1) A UK institution that meets the conditions set out in article 8(2) must provide the notice referred to in paragraph (2) of this article to its account holder if—

(a) it has previously received from the account holder a family member statement, and

(b) the statement of eligibility for the eligible individual who has signed the family member statement is more than twenty four months old and no more recent statement of eligibility has been received.

(2) The notice required under paragraph (1) must contain—

(a) a statement that the account-holder's deposits will become core deposits if within thirty months following the date of the statement of eligibility for the individual who has signed the family member statement, the account-holder has not provided a further family member statement;

(b) a statement that if the account-holder's deposits become core deposits they must be held in a ring-fenced body, an exempt institution (other than a body falling within article 6(1)(b)) or a building society;

(c) a request that the account holder responds in writing by the transfer date—

(i) providing to the institution a further family member statement or a statement of eligibility;

(ii) nominating a ring-fenced body to which the relevant deposits will be transferred if they become core deposits; or

(iii) confirming that they will accept repayment of the full amount of the deposits and providing the details of the account to which such repayment should be made or of an address to which payment could be sent;

(d) a statement that if the account holder fails to respond in writing before the date on which the deposits become core deposits they will be transferred to a ring-fenced body, and identifying the body to which the deposits will be transferred; and

(e) such other information as may be specified by the PRA or the FCA in rules from time to time.

(3) Where the UK institution is a member of a group which contains one or more ring-fenced bodies, the ring-fenced body identified under paragraph (2)(d) must be a member of the same group.

(4) If by the transfer date the account holder has not provided a further family member statement or a statement of eligibility, then on the day immediately following the transfer date the institution must—

(a) transfer the relevant deposits to the ring-fenced body nominated by the account holder in accordance with paragraph (2)(c)(ii) of this article,

(b) repay to the account holder the full amount of the relevant deposits by electronic payment to an account notified by the account-holder or by sending payment to an address notified by the account holder, or

(c) if the account holder has failed to respond in writing by the transfer date, transfer the relevant deposits to the ring-fenced body specified in the statement given to the account holder under paragraph 2(d) of this article.

Name
Name
Two of the Lords Commissioners of Her Majesty's Treasury

Date

SCHEDULE 1

Article 2

PART 1

Statement of Eligibility

1. The statement to be provided in relation to an eligible individual must be in the following form—

"**Statement for Eligible Individuals**

Part 1: Election to Bank with a Non Ring-Fenced Body

I freely elect to place deposits in a non ring-fenced body.

I understand that:

(1) a non ring-fenced body is a body which is not subject to ring-fencing and which does not hold any core deposits;

(2) a non ring-fenced body is distinct from a body which is not subject to ring-fencing because, although it holds some core deposits, it has been exempted from the ring-fencing regime (an 'exempt body');

(3) I may place deposits with an exempt body without making this statement;

(4) but providing this statement enables me additionally to place deposits with a non ring-fenced body;

(5) however even if I make this statement I will not be required to place any deposit with a non ring-fenced body, and may still place deposits with a ring-fenced body or an exempt body; and

(6) both a non ring-fenced body and an exempt body may—

(a) conduct investment activities such as dealing in investments as principal, which a ring-fenced body cannot, and

(b) have greater exposure to relevant financial institutions than a ring-fenced body.

If after twenty four months following the date of this statement I have not provided a more recent statement to a non ring-fenced body with which I have placed deposits, I will be given an opportunity to provide a more recent statement, to request that my deposits are repaid to me or to nominate a ring-fenced body to which my deposits may be transferred.

If within thirty months of the date of this statement I have not provided a more recent statement to a non ring-fenced body with which I have placed deposits, requested repayment or nominated a ring-fenced body to which my deposits may be paid, my deposits will be transferred to a ring-fenced body within the meaning of the Financial Services and Markets Act 2000.

Part 2: Declaration of High Net Worth

I declare that I am a high net worth individual.

I am a high net worth individual because on average in the period of one year ending on the date of this statement I held free and investable assets to the value of £250,000 or more. Free and investable assets do not include—

(1) the property which is my primary residence or the outstanding proceeds of any loan secured on that residence;

(2) any rights of mine under a qualifying contract of insurance within the meaning of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, or

(3) any benefits (in the form of pensions or otherwise) which are payable on the termination of my service or on my death or retirement and to which I (or my dependants) are, or may be, entitled.

For the purposes of this statement I have calculated my average free and investable assets as follows—

(1) calculate their total free and investable assets at the end of each month in the relevant year to give monthly totals;

(2) add these monthly totals together and divide by twelve.

Signature: Date:”

Statement by Countersigning Chartered Accountant

I confirm that I am a chartered accountant and am a member of the professional body or bodies stated below.

I have investigated the assets of the person to whom this statement relates and I am satisfied that they are a high net worth individual.

They are a high net worth individual because on average in the period of one year ending on the date of this statement they held free and investable assets to the value of £250,000 or more. Free and investable assets do not include—

(1) the property which is their primary residence or the outstanding proceeds of any loan secured on that residence;

(2) any rights of theirs under a qualifying contract of insurance within the meaning of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, or

(3) any benefits (in the form of pensions or otherwise) which are payable on the termination of their service or on their death or retirement and to which they are (or their dependants are), or may be, entitled.

For the purposes of this statement I have calculated their average free and investable assets as follows—

(1) calculate their total free and investable assets at the end of each month in the relevant year to give monthly totals;

(2) add these monthly totals together and divide by twelve.

Signature: Date:”

PART 2

Family Member Statement

2. The statement to be provided by an eligible family member must be in the following form. If the person to whom it relates has not attained the age of eighteen, it may be signed on their behalf by an eligible individual of whose family they are a member—

“**Statement for Eligible Family Member**

Part 1: Election to Bank with a Non Ring-Fenced Body

I freely elect to place deposits in a non ring-fenced body.

I understand that:

(1) a non ring-fenced body is a body which is not subject to ring-fencing and which does not hold any core deposits;

(2) a non ring-fenced body is distinct from a body which is not subject to ring-fencing because, although it holds some core deposits, it has been exempted from the ring-fencing regime (an ‘exempt body’);

(3) I may place deposits with an exempt body without making this statement;

(4) but providing this statement enables me additionally to place deposits with a non ring-fenced body;

(5) however even if I make this statement I will not be required to place any deposit with a non ring-fenced body, and may still place deposits with a ring-fenced body or an exempt body; and

(6) both a non ring-fenced body and an exempt body may—

(a) conduct investment activities such as dealing in investments as principal, which a ring-fenced body cannot, and

(b) have greater exposure to relevant financial institutions than a ring-fenced body.

Part 2: Declaration of Family Relationship

I declare that I am a family member of the eligible individual who has signed this statement.

I am a family member of the eligible individual because I am:

(1) that individual’s spouse or civil partner;

(2) a person (whether of a different sex or the same sex) with whom the individual lives as a partner in an enduring family relationship, other than that individual's grandparent or grandchild, sister, brother, aunt or uncle;

(3) the individual's child or step-child;

(4) a child or step-child of a person within paragraph (2) (and who is not a child or step-child of the individual) who lives with the individual and has not attained the age of 18;

(5) a parent of the individual.

I understand that:

(1) I will continue to be an eligible family member only as long as the eligible individual who has signed this statement continues to be an eligible individual;

(2) The eligible individual who has signed this statement is an eligible individual because they have provided a certificate of eligibility, which is attached to this statement;

(2) On the date when that statement of eligibility is thirty months old, if I do not provide a further family member statement (attaching a more recent statement of eligibility for an individual of whose family I am a member), I will cease to be an eligible family member.

If after twenty four months following the date of the attached statement of eligibility I have not provided a more recent version of this statement (a family member statement) to a non ring-fenced body with which I have placed deposits, I will be given an opportunity to provide a more recent family member statement (attaching a more recent statement of eligibility for an individual of whose family I am a member), to request that my deposits are repaid to me or to nominate a ring-fenced body to which my deposits may be transferred.

If within thirty months following the date of the attached statement of eligibility I have not provided a more recent family member statement to a non ring-fenced body with which I have placed deposits, requested repayment or nominated a ring-fenced body to which my deposits may be paid, my deposits will be transferred to a ring-fenced body within the meaning of the Financial Services and Markets Act 2000.

Signature of family member: Date:

Signature of eligible individual: Date:"

EXPLANATORY NOTE

(This note is not part of the Order)

This Order specifies classes of institution which are exempted from the definition of "ring-fenced body in section 142A of the Financial Services and Markets Act 2000 (c.8) ("the Act"). The classes of institution which are exempted are banks which hold deposits below a specified size threshold of £25 billion of "core deposits", insurance companies, credit unions and industrial and provident societies.

Article 3 defines core deposit and provides that if a deposit is not core, then the activity of accepting it is not a core activity. A deposit is core unless one of four conditions is met. The first is that it is placed in an EEA account for which one or more of the account holders have certified that they are an eligible individual. To certify that they are an eligible individual a person must certify both that they wish to place deposits with a non ring-fenced body and that they are a high net worth individual. The second is that it is placed in an EEA account for which the account holder has certified that they are a member of an eligible individual's family. To certify that they are a member of an eligible individual's family a person must certify both that they wish to place deposits with a non ring-fenced body and that they are a member of an eligible individual's family. The third condition is that the deposit is placed in an EEA account for which one or more of the account holders has certified that it is a large organisation. The fourth condition is that the deposit is placed in an EEA account for which one or more of the account holders is a relevant financial institution.

Article 4 defines large organisation for the purposes of the Order.

Article 5 defines relevant financial institution for the purposes of the Order. Article 5(2) lists the classes of relevant financial institution and article 5(3) sets out exceptions which are not within the definition of relevant financial institution.

Article 6 identifies those classes of institution that are not ring-fenced bodies, namely: UK institutions (other than members of groups) which in total hold core deposits the average value of which over three financial years is less than £25 billion, insurance companies, credit unions and industrial and provident societies.

Article 7 makes provision for UK institutions which are members of groups. All UK institutions in the group which hold core deposits will be ring-fenced bodies unless the total core deposits held by all the UK institutions added together is less than £25 billion.

Article 8 specifies the steps a non ring-fenced body must take if it is holding non core deposits, which must be considered to be core deposits because the account-holder has certified that they are an eligible individual or a large organisation but has not renewed that certificate within thirty months (in the case of an eligible individual) or eighteen months (in the case of a large organisation). This article also sets out preparatory steps the non-ring fenced body must take prior to such deposits becoming core. Such core deposits may only be held in a ring-fenced body.

Article 9 specifies the steps a non ring-fenced body must take if it is holding non core deposits which become core because the account holder has certified that they are a member of an eligible individual's family, but that eligible individual ceases to be an eligible individual. This Article also sets out steps the non-ring fenced body must take prior to such deposits becoming core. Such deposits may only be held in a ring-fenced body.

Part 1 of the Schedule sets out the form and content of the statement that an individual must make to certify that they are an eligible individual. It provides for the statement to be countersigned by a chartered accountant.

Part 2 of the Schedule sets out the form and content of the statement that an individual must make to certify that they are a family member of an eligible individual. It provides for the statement to be countersigned by the relevant eligible individual.

An Impact Assessment of the effect of the Financial Services (Banking Reform) Bill, and the secondary legislation to be made under it (including this Order) on the costs of business and the voluntary sector has been prepared and is available on HM Treasury's website (www.gov.uk/treasury) or from the Banking Reform Bill Team, HM Treasury, 1 Horse Guards Road, London SW1A 2HQ and is annexed to the Explanatory Memorandum for this Order.

B Excluded Activities and Prohibitions Order

Draft Order laid before Parliament under section 142N of the Financial Services and Markets Act 2000, for approval by resolution of each House of Parliament.

D R A F T   S T A T U T O R Y   I N S T R U M E N T S

201* No.

BANKS AND BANKING

Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 201*

Made - - - -	***
Coming into force - -	***

The Treasury, in the exercise of the powers conferred on them by sections 142D, 142E and 142F of the Financial Services and Markets Act 2000, make the following Order.

In accordance with section 142Z of the Financial Services and Markets Act 2000(**a**), a draft of this Order has been laid before Parliament and approved by a resolution of each House of Parliament;

PART 1

GENERAL

Citation, commencement and interpretation

1.—(1) This Order may be cited as the Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 201*.

(2) This Order comes into force on [ ].

(3) In this Order—

"account holder" means any person who has a current account or a deposit account with a ring-fenced body, other than a relevant financial institution;

"the Act" means the Financial Services and Markets Act 2000;

"alternative investment fund" means an AIF within the meaning of Article 4(1)(a) of Directive of the European Parliament and of the Council of 8 June 2011 on alternative investment fund managers(**b**);

"alternative investment fund manager" means an AIFM within the meaning of Article 4(1)(b) of the Directive of the European Parliament and of the Council of 8 June 2011 on alternative investment fund managers;

(**a**) 2000 c. 8. Sections 142A to 142Z1 were inserted into the Act by the Financial Services (Banking Reform) Act 201*, section 4.

(**b**) OJ L174, 1.7.2011, p.1.

"building society" means a building society incorporated (or deemed to be incorporated) under the Building Societies Act 1986(**a**);

"commodity" means any produce of agriculture, forestry or fisheries, or any mineral, either in its natural state or having undergone only such processes as are necessary or customary to prepare the produce or mineral for the market;

"contractually based investments" has the meaning given in article 3(1) of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001;

"credit institution" has the meaning given in Article 4.1(1) of the prudential requirements regulation;

"credit institutions directive" means the Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC(**b**);

"default risk", in relation to a ring-fenced body, means the risk that—

(a) one or more persons will become unwilling or unable to pay or repay a sum or sums owing at law or in equity to the ring-fenced body or to a subsidiary undertaking of the ring-fenced body, or

(b) the value of any security taken by the ring-fenced body in connection with a loan made by the ring-fenced body will fall between the time when the loan is made and the security is enforced;

"derivative instrument" includes any of the instruments listed in paragraphs (4) to (10) of Section C of Annex 1 to the markets in financial instruments directive;

"documentary credit" has the same meaning as "credit" as defined in article 2 of the Uniform Customs and Practice for Documentary Credits (UCP 600) published by the International Chamber of Commerce in July 2007, as amended from time to time;

"exposure" means, in relation to a person ("P"), the loss which may be incurred by P if—

(a) P's counterparty fails to meet their obligations (whether to P or to another person), or

(b) P realises assets, including assets from positions which are not reflected in P's balance sheet;

"financial holding company" has the meaning given in Article 4.1(20) of the prudential requirements regulation;

"financial institution exposure" means—

(a) an exposure under, or which relates to, a contract with a relevant financial institution, or

(b) an exposure to, or which relates to, the securities or other financial instruments issued by a relevant financial institution,

but shall not include an exposure under a contract with a relevant financial institution which relates solely to the safeguarding and administration of assets of the ring-fenced body by the relevant financial institution;

"insurance holding company" means a parent undertaking which—

(a) is not a mixed financial holding company, and

(b) the main business of which is to acquire and hold participations in subsidiary undertakings, where—

  (i) those subsidiary undertakings are exclusively or mainly insurance or reinsurance undertakings or third-country insurance or reinsurance undertakings, and

  (ii) at least one of such subsidiary undertakings is an insurance or reinsurance undertaking;

(**a**) 1986 c. 53.
(**b**) OJ L 174 27.6.2013, p338.

"insurance undertaking" means an undertaking which has received authorisation as an insurance undertaking in accordance with the first non-life directive or the life assurance consolidation directive;

"liquid assets buffer" means the buffer of liquid assets which the ring-fenced body is required to have as part of its liquidity resources under section BIPRU 12.2.8 of the PRA Handbook, as amended from time to time;

"liquidity risk" means the risk that the ring-fenced bank does not have, or is unable to obtain, sufficient financial resources to enable it to meet its financial obligations as they fall due;

"management company" has the meaning given in Article 2(1)(b) of the UCITS Directive;

"mixed financial holding company" has the meaning given in Article 2(15) of Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate(**a**)) (disregarding any decision taken under Article 3(3) of that Directive);

"own funds" means own funds as defined in Article 4.1(118) of the prudential requirements regulation;

"payment services" has the same meaning as in regulation 2(1) of the Payment Services Regulations 2009(**b**);

"PRA Handbook" means the Handbook of Rules and Guidance made by the Prudential Regulation Authority (as that Handbook has effect from time to time);

"prudential requirements regulation" means Regulation (EU) No 575/2013/EU of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms(**c**);

"reinsurance undertaking" means an undertaking which has received authorisation in accordance with Article 3 of the reinsurance directive;

"relevant financial institution" has the meaning given in article 2;

"security" has the meaning given in article 3(1) of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001(**d**);

"securitisation company" has the meaning given in section 623 of the Corporation Tax Act 2010(**e**);

"short-term exposures" means—

(a) in the case of foreign exchange transactions, exposures arising in the ordinary course of settlement during the two working days following payment,

(b) in the case of transactions for the purchase or sale of securities, exposures arising in the ordinary course of settlement during five working days following payment or delivery of the securities, whichever is the earlier,

(c) exposures arising in the case of the provision of money transmission or other client activity which do not last longer than the following business day as described in paragraph 6(c) of Article 390 of the prudential requirements regulation,

(d) intraday exposures to institutions providing money transmission including the execution of payment services, clearing and settlement in any currency and correspondent banking;

"third country insurance undertaking" means an undertaking which would require authorisation in accordance with the first non-life directive or the life assurance consolidation directive if it had its head office in the EEA;

(**a**) OJ L35, 11.02.2003, p1.
(**b**) S.I. 2009/209.
(**c**) OJ L 176, 27.6.2013, p1.
(**d**) S.I. 2001/544. There are amendments to article 3(1), but none are relevant to this Order.
(**e**) 2010 c.4.

"third country reinsurance undertaking" means an undertaking which would require authorisation in accordance with the reinsurance directive if it had its head office in the EEA;

"UCITS" has the meaning given in Article 1.2 of the UCITS Directive.

Relevant financial institution

2.—(1) For the purposes of this Order, a "relevant financial institution" is an institution which falls within one of the classes described in paragraph (2), and which is not within one of the exceptions set out in paragraph (3).

(2) The classes referred to in paragraph (1) are—

(a) credit institutions;

(b) investment firms;

(c) securitisation companies;

(d) insurance undertakings, insurance holding companies, third country insurance undertakings, reinsurance undertakings and third country reinsurance undertakings;

(e) UCITS (wherever established), alternative investment funds, or other forms of collective investment scheme;

(f) management companies or alternative investment fund managers; and

(g) financial holding companies and mixed financial holding companies.

(3) The exceptions referred to in paragraph (1) are—

(a) ring-fenced bodies;

(b) building societies;

(c) bodies corporate—

(i) whose purpose, or principal purpose, is that of making loans which are secured on residential property and which are funded substantially by their members, and

(ii) which are incorporated under the law of an EEA state other than the United Kingdom;

(d) those institutions referred to in Article 2.5 of the credit institutions directive; and

(e) investment firms which are not authorised to carry on by way of business (in the UK or the EEA) the activities specified by either article 14 (dealing in investments as principal) or article 21 (dealing in investments as agent) of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001(**a**).

PART 2

EXCLUDED ACTIVITIES AND EXCEPTIONS

Excluded activities: commodities trading

3. A ring-fenced body may not deal in commodities, except where the commodities in question form part of the security taken for a loan provided by the ring-fenced body, and the ring-fenced body is realising that security.

Excluded activities: general exceptions

4.—(1) A ring-fenced body does not carry on an excluded activity by entering into a transaction with another person if the sole or main reason for which the ring-fenced body entered into the transaction, either by itself or in combination with other transactions, is that of limiting the extent

(**a**) S.I. 2001/544. Article 14 was amended by S.I. 2006/3384. Article 21 was amended by S.I. 2003/1476; 2006/3384.

to which the business of the ring-fenced body will be adversely affected by any of the following factors—

(a) changes in interest rates, exchange rates or commodity prices;

(b) default risk;

(c) liquidity risk.

(2) A ring-fenced body does not carry on an excluded activity by buying, selling or subscribing for investments where—

(a) the investments concerned qualify for inclusion in the ring-fenced body's liquid assets buffer under section BIPRU 12.7.2 of the PRA Handbook, and

(b) the transaction concerned does not give rise to a financial institution exposure for the ring-fenced body which is prohibited under article 8(1).

(3) A ring-fenced body does not carry on an excluded activity by acquiring shares or an entitlement to shares from a company ("the debtor") to which the ring-fenced body had made a loan where—

(a) the shares concerned form part of the ordinary working capital of the debtor, and

(b) the consideration for the acquisition is the release by the ring-fenced body of part or all of the amount owed by the debtor to the ring-fenced body under the loan.

(4) A ring-fenced body does not carry on an excluded activity by disposing of shares acquired by the ring-fenced body in accordance with paragraph (3).

(5) A ring-fenced body does not carry on an excluded activity—

(a) by transferring securities or contractually based investments to a securitisation company where all the assets held by the securitisation company in question consist of assets transferred to it, or otherwise acquired by it, from the ring-fenced body, or revenue related to those assets, or

(b) by acquiring any instrument creating or acknowledging indebtedness issued by that securitisation company.

Excluded activities: central bank exemption

5.—(1) A ring-fenced body does not carry on an excluded activity where—

(a) it enters into a transaction with a central bank, or with a wholly owned subsidiary of a central bank, which would fall within the regulated activity of dealing in investments as principal (or which would fall within that activity if the transaction took place in the United Kingdom); or

(b) it sells commodities to, or buys commodities from, a central bank, or a wholly owned subsidiary of a central bank.

(2) For the purposes of this article—

(a) "company" includes companies incorporated outside the United Kingdom;

(b) a company is to be regarded as wholly owned by a central bank at any time if at that time—

(i) it is a company of which no person other than the central bank or a nominee of the central bank is a member, or

(ii) it is a wholly owned subsidiary of a company within sub-paragraph (i);

(c) a company ("A") is a "subsidiary" of another company ("B") if B—

(i) holds a majority of the voting rights in A, or

(ii) is a member of A and has the right to appoint or remove a majority of A's board of directors, or

(iii) is a member of A, and controls alone, pursuant to an agreement with other members, a majority of the voting rights in A;

(d) a company ("A") is a "wholly owned "subsidiary" of a central bank or another company ("B") if A has no members except B, and B's wholly owned subsidiaries or persons acting on behalf of B or its wholly owned subsidiaries.

Excluded activities: derivatives

6.—(1) A ring-fenced body does not carry on an excluded activity by entering into transactions with any one or more of its account holders if—

(a) the transaction consists of the sale of investments which satisfy the requirements listed in paragraph (2), and

(b) all the conditions set out in paragraph (3) are satisfied.

(2) The requirements referred to in paragraph (1) are—

(a) the investment is a derivative instrument which relates to currencies, interest rates or commodities;

(b) the potential profit or loss which may be realised in relation to the derivative instrument will be directly proportional to—

(i) the change in value of the currencies or commodities, or

(ii) the change in the level of the interest rates,

to which the derivative instrument relates;

(c) there is evidence available to assess the fair value of the investment concerned in accordance with international financial reporting standard 13 ("IFRS 13") on fair value measurement issued by the International Accounting Standards Board, as that reporting standard is amended from time to time, and that evidence would be considered to constitute a level 1 input within the meaning of paragraph 76 of IFRS 13, or a level 2 input within the meaning of paragraphs 81 to 82 of IFRS 13.

(3) The conditions referred to in paragraph (1) are—

(a) the position risk requirement attributable—

(i) to all investments traded under this article, and

(ii) any investments traded by the ring-fenced body under article 3(1) for the purpose of hedging risks to its business arising in relation to the investments referred to in sub-paragraph (i) (provided that those investments are hedged separately from any other investments traded by the ring-fenced body under article 3(1)),

is at all times less than 0.5% of the ring-fenced body's own funds, and

(b) the sum of the position risk requirements attributable to each individual transaction with an account holder under article 6 is at all times less than 20% of the credit risk capital requirement of the ring-fenced body and in calculating the sum of the position risk requirements, no position risk requirement may be set off against any other position risk requirement.

(4) For the purposes of this article, the position risk requirement shall be calculated in accordance with section BIPRU 7 of the PRA Handbook (excluding paragraphs 7.9.1 to 7.10.149 of that section) on the assumption that the positions associated with those investments are all held in the trading book of the ring-fenced body, and for the purposes of paragraph (3)—

(a) "credit risk capital requirement" has the meaning given in the glossary section of the PRA Handbook,

(b) "position risk requirement" has the meaning given in the glossary section of the PRA handbook, and

(c) "trading book" has the meaning given in section BIPRU 1.2 of the PRA Handbook.

PART 3

PROHIBITIONS AND EXCEPTIONS

Prohibitions: inter-bank payment systems

7.—(1) A ring-fenced body is prohibited from entering into any transaction enabling it to use services provided through an inter-bank payment system unless—

(a) it is a direct participant in the system, or

(b) either or both of the conditions set out in paragraph (2) are satisfied.

(2) The conditions are—

(a) the ring-fenced body is not eligible to become a direct participant in the inter-bank payment system concerned under the rules governing that payment system, or

(b) the cost of becoming a direct participant in the inter-bank payment system is disproportionate to the benefit which the ring-fenced body can expect to receive from use of the system, taking account of the extent to which the ring-fenced body proposes to use that system.

(3) In this article—

"direct participant" means an institution which is able to access the services provided through an inter-bank payment system otherwise than through an intermediary;

"inter-bank payment system" has the meaning given by section 182 of the Banking Act 2009(**a**), but does not include arrangements made by the ring-fenced body with another bank for a correspondent banking relationship.

Prohibitions: financial institution exposures

8.—(1) A ring-fenced body is prohibited from entering into any transaction which gives rise to a financial institution exposure for the ring-fenced body except in the circumstances set out in paragraphs (2) to (13) below.

(2) A ring-fenced body may enter into a transaction which results in a financial institution exposure for the ring-fenced body if the sole or main reason for which the ring-fenced body is entering into the transaction either by itself or in combination with other transactions is that of limiting the extent to which the ring-fenced body will be affected by any of the following factors—

(a) changes in interest rates, exchange rates or commodity prices;

(b) default risk.

(3) A ring-fenced body may enter into a transaction which results in a financial institution exposure for the ring-fenced body where the financial institution concerned is a member of the same group as the ring-fenced body, provided that—

(a) the exposure concerned is not a short-term exposure;

(b) the exposure concerned is not prohibited under rules made by the regulator under the Act; and

(c) the transaction concerned is a commercial transaction conducted on arm's length terms.

(4) A ring-fenced body may enter into a transaction which results in a financial institution exposure where the exposure concerned is a short term exposure, and—

(a) the transaction does not increase the sum of the ring-fenced body's short term exposures to an amount which at the time of the transaction is entered into is greater than or equal to 10% of the ring-fenced body's own funds; and

(**a**) 2009 c.1.

(b) the transaction does not increase the ring-fenced body's exposure to the financial institution concerned to an amount which at the time of the transaction is greater than or equal to 2% of the ring-fenced body's own funds.

(c) the exposure resulting from that transaction lasts no longer than 5 working days.

(5) A ring-fenced body may provide overdraft facilities to a customer financial institution in connection with a current account held by that institution with the ring-fenced body, provided that—

(a) any sums borrowed by the customer financial institution under the overdraft are—

(i) only used by that institution to cover its short term exposures, and

(ii) repaid to the bank within five working days of the day on which they are drawn down;

(b) the total exposure of the ring-fenced body under overdrafts granted to customer financial institutions at any one time does not exceed an amount which is greater or equal to 10% of the ring-fenced body's own funds;

(c) the ring-fenced body's exposure to the financial institution concerned never increases above an amount equal to 2% of the ring-fenced body's own funds.

(6) For the purposes of paragraph (5) "customer financial institution" is a relevant financial institution to which the ring-fenced body provides clearing services.

(7) A ring-fenced body may hold an account (a nostro account) with a credit institution which is not a ring-fenced body, and provide an account (a vostro account) for such a credit institution provided that the operation of those accounts does not expose the ring-fenced body to a financial institution exposure which is not permitted under this article.

(8) A ring-fenced body may enter into a transaction with a relevant financial institution for the purpose of issuing or confirming a documentary credit for the benefit of a customer of the ring-fenced body provided that—

(a) the customer is not a relevant financial institution within subparagraphs (a) to (c) or (e) to (g) of article 2(2);

(b) the documentary credit—

(i) is issued in connection with the supply of goods or services, and specifies the transactions to which it relates;

(ii) specifies the total credit available under it;

(iii) is subject to the Uniform Customs and Practice for Documentary Credits (UCP 600) published by the International Chamber of Commerce in July 2007, as amended from time to time;

(c) the total exposure of the ring-fenced body in relation to documentary credits issued or confirmed under this paragraph and to guarantees issued or confirmed under paragraph (9) does not exceed an amount which on the date of the transaction is greater than or equal to 10% of the ring-fenced body's own funds; and

(d) the transaction does not increase the ring-fenced body's exposure to the financial institution concerned to an amount which at the time of the transaction is greater than or equal to 5% of the ring-fenced body's own funds.

(9) A ring-fenced body may enter into a transaction with a relevant financial institution for the purpose of issuing or confirming a guarantee on behalf of a customer of the ring-fenced body which is not a relevant financial institution provided that—

(a) the customer is not a relevant financial institution;

(b) the guarantee—

(i) is issued in connection with the supply of goods or services, and specifies the transactions to which it relates;

(ii) specifies the total amount which may be payable under it;

(c) is subject to the ICC Uniform Rules for Demand Guarantees (URDG 758) published by the International Chamber of Commerce in July 2010, as amended from time to time;

(d) the total exposure of the ring-fenced body in relation to documentary credits issued or confirmed under paragraph (8) and to guarantees issued or confirmed under this paragraph at any one time does not exceed an amount which on the date of the transaction is greater than or equal to 10% of the ring-fenced body's own funds, and

(e) the transaction does not increase the ring-fenced body's exposure to the financial institution concerned to an amount which at the time of the transaction is greater than or equal to 5% of the ring-fenced body's own funds.

(10) A ring-fenced body may enter into a transaction which gives rise to an exposure to a securitisation company where the only assets held by the securitisation company consist of assets transferred to it, or otherwise acquired by it, from the ring-fenced body, and revenue related to those assets.

(11) A ring-fenced body may enter into a transaction which gives rise to an exposure to a securitisation company ("A") where—

(a) the only business of A (apart from incidental activities) is to acquire, hold and manage assets from a company which is not a relevant financial institution ("B");

(b) the results of A are disclosed in consolidated accounts for B, or for a group including B, for the financial year in which the transaction is entered into; and

(c) all or part of those assets are being used to form the whole or part of the security for a loan from the ring-fenced body to A for the benefit of B.

(12) A ring-fenced body ("C") may enter into a transaction with a relevant financial institution ("D") pursuant to an agreement with D—

(a) for the transfer of its own assets to D on terms—

(i) imposing an obligation on C to buy those assets, or assets of the same description, from D at a subsequent time; or

(ii) imposing an obligation on D to transfer those assets to C at one or more subsequent times;

(b) for the transfer of liquid assets from D to C on terms—

(i) imposing an obligation on D to buy those assets, or assets of the same description from C at a subsequent time; or

(ii) imposing an obligation on C to transfer those assets to D at one or more subsequent times;

provided that the sole or main purpose of the transaction is to manage assets in C's liquid assets buffer.

(13) For the purposes of paragraph (12) "liquid assets" means assets which qualify for inclusion in the liquid assets buffer of the ring-fenced body under rules 12.7.2 of section BIPRU of the PRA Handbook.

PRA obligations

9.—(1) The PRA must make rules for the purposes of this Order requiring the disclosure by ring-fenced bodies of information in relation to—

(a) their short term exposures, and

(b) their exposure to letters of credit and guarantees.

(2) The rules to be made under paragraph (1) must require the disclosure to the PRA of sufficient information to permit the PRA to monitor the compliance of ring-fenced bodies with article 8.

Prohibitions: Non-EEA branches and subsidiaries

10.—(1) A ring-fenced body may not—

(a) maintain or establish a branch in any country or territory which is neither an EEA member state nor one of the crown dependencies specified in paragraph (3), or

(b) subject to paragraph (2), have a participating interest in any undertaking which is incorporated in or formed under the law of a country or territory which is not an EEA member state (a “non EEA undertaking”).

(2) A ring-fenced body may, subject to rules made by the PRA, have a participating interest in a non-EEA undertaking which does not carry on any activities that would be regulated activities if carried on in the United Kingdom.

(3) The crown dependencies specified are—

(a) the Isle of Man,

(b) the Bailiwick of Jersey, and

(c) the Bailiwick of Guernsey.

(4) For the purposes of this article—

(a) “branch” means a place of business that forms a legally dependent part of the ring-fenced body and conducts directly all or some of the operations inherent in its business;

(b) “participating interest” has the meaning given in section 421A of the Act(**a**).

[name]
[name]
[date] Two of the Lords Commissioners of Her Majesty’s Treasury

EXPLANATORY NOTE

(This note is not part of the Order)

This Order defines the circumstances in which ring-fenced bodies will be able to deal with investments as principal by providing for exceptions to the excluded activity set out in section 142D of the Financial Services and Markets Act 2000 in relation to the management by the ring-fenced body of its own risks or of its liquid assets buffer or the provision of derivatives to its clients for limited purposes. The Order also imposes prohibitions on ring-fenced bodies under section 142E, which (with the exceptions provided for) limit the way in which a ring-fenced body may have access to clearing and settlement services provided by a recognised interbank payment system, restrict the exposures a ring-fenced body may have to relevant financial institutions, and ensure that a ring-fenced body may not have a subsidiary in a country outside the EEA (other than operational subsidiaries), or branches in any country outside the EEA or the crown dependencies.

Article 1 defines the terms used in the Order.

Article 2 defines relevant financial institution for the purposes of the Order.

Part 2 provides for an additional excluded activity (commodities trading), and sets out the circumstances in which ring-fenced bodies may engage in dealing in investments as principal, and commodities trading, as exceptions to the excluded activities.

Article 3 provides that a ring-fenced body may not engage in commodities trading.

(**a**) Section 421A was inserted into the Financial Services and Markets Act 2000 by S.I. 2008/948.

Article 4 provides for exceptions to the excluded activity of dealing with an investment as principal where the ring-fenced body is managing the risks associated with its business, including for example its interest rate risk, exchange rate risk, or liquidity risk. The ring-fenced body is also permitted to deal in assets included in its liquid assets buffer and shares acquired in exchange for a loan write-off, and to transfer assets to its own securitisation company.

Article 5 provides for an exception to the excluded activities of dealing in investments as principal and commodities trading where the ring-fenced body is entering into a transaction with a central bank.

Article 6 sets out the conditions which must be satisfied by a ring-fenced body which wishes to deal in derivative instruments with its account holders.

Part 3 imposes a number of prohibitions on ring-fenced bodies, and provides for exemptions to those prohibitions.

Article 7 ensures that a ring-fenced body may not use services provided through a recognised inter-bank payment system indirectly by an intermediary unless it is not possible for the ring-fenced body to become a member of that system or where the cost of becoming a member is disproportionate because of the limited extent to which the ring-fenced body is likely to use it.

Article 8 sets out the circumstances in which a ring-fenced body is permitted to have an exposure to a relevant financial institution. Permitted exposures include exposures arising in relation to transactions entered into by the ring-fenced body for risk management purposes, intra-group transactions, transactions resulting in short-term exposures, and transactions related to documentary credits and guarantees. A ring-fenced body is permitted to provide overdrafts to customer financial institutions (subject to conditions), and to hold accounts with another credit institution (again, subject to conditions). Provision is also made to permit a ring-fenced bank to enter into transactions with its own securitisation company.

Article 9 imposes obligations on the PRA to make rules on disclosure by ring-fenced bodies.

Article 10 prohibits a ring-fenced body from having a branch outside the EEA and the crown dependencies or a subsidiary (other than a subsidiary which does not carry out any activities regulated in the UK) in a country or territory outside the EEA.

An Impact Assessment of the effect of the Financial Services (Banking Reform) Bill, and the secondary legislation to be made under it (including this Order) on the costs of business and the voluntary sector has been prepared and is available on HM Treasury's website (www.gov.uk/treasury) or from the Banking Reform Bill Team, HM Treasury, 1 Horse Guards Road, London SW1A 2HQ and is annexed to the Explanatory Memorandum for this Order.

C

Banking Reform (Loss Absorbency Requirements) Order

Draft Order laid before Parliament under section 142Z of the Financial Services and Markets Act 2000, for approval by resolution of each House of Parliament.

DRAFT STATUTORY INSTRUMENTS

201* No.

BANKS AND BANKING

Banking Reform (Loss Absorbency Requirements) Order 201*

Made - - - - ***

Coming into force - - ***

The Treasury, in exercise of the powers conferred by sections 142Y and 428(3) of the Financial Services Act 2000(**a**), make the following Order.

In accordance with section 142Z of the Financial Services and Markets Act 2000, a draft of this Order has been laid before Parliament and approved by a resolution of each House of Parliament.

Citation, commencement and interpretation

1.—(1) This Order may be cited as the Banking Reform (Loss Absorbency Requirements) Order 2013.

(2) This Order comes into force on [ ].

(3) In this Order—

"appropriate regulator" means, in relation to a PRA-authorised person, or a parent undertaking of a PRA-authorised person, the PRA, and in every other case, the FCA;

"bank" has the meaning given in section 2 of the Banking Act 2009(**b**);

"Basel Committee Framework" means "A Framework for dealing with domestic systemically important banks" published by the Basel Committee on Banking Supervision in October 2012;

"building society" means a building society incorporated (or deemed to be incorporated) under the Building Societies Act 1986(**c**);

"core deposits" has the meaning given in article 3(2) of the Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 201*(**d**);

"credit institutions directive" means the Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC(**e**);

(**a**) 2000 c. 8. Sections 142A to 142Z1 were inserted into the Financial Services and Markets Act 2000 (c.8) by the Financial Services (Banking Reform) Act 201*, section 4.
(**b**) 2009 c.1. Section 2(1) was amended by schedule 17 to the Financial Services Act 2012 (c. 21).
(**c**) 1986 c. 53.
(**d**) S.I. 201*/*.
(**e**) OJ L 176 27.6.2013, p338.

“cumulative total of own funds” in relation to a number of undertakings means the sum of the own funds held by each of those undertakings, which do not consist of capital or debt subscribed to by undertakings within the same group;

“cumulative total risk-weighted exposure” in relation to a number of undertakings means the sum of the risk-weighted exposures held by each of those undertakings;

“debt requirement” has the meaning given in article 2;

“domestic systemically important institution” means a bank or building society identified as such by the PRA in accordance with article 3(1), and included on the list published under article 3(2);

“EEA company” means a company governed by the law of an EEA state;

“eligible debt instruments” means any debt instruments which—

(a) are issued in relation to eligible liabilities, and

(b) for which the period remaining until their maturity is greater than or equal to 12 months;

“eligible liabilities” has the meaning given in Article [2(62)] of the [recovery and resolution directive];

“equity surcharge” means the additional equity which the Basel Committee on Banking Supervision proposed should be held by G-SIBs as an additional loss absorbency requirement in “Global systemically important banks: assessment methodology and the additional loss absorbency requirement (rules text)” published in November 2011;

“exposure” means an asset or off-balance sheet item;

“G-SIB” means a group identified as a global systemically important bank by the Financial Stability Board in the Annex to the “Update of group of global systemically important banks” published by the Financial Stability Board on 1 November 2012, or any updated version of that list published by the Financial Stability Board subsequently;

“overseas subsidiary undertakings” means subsidiary undertakings which are not incorporated in an EEA member state;

“own funds” means own funds as defined in Article 4.1(118) of the prudential requirements regulation, but does not include any institution-specific countercyclical buffer which a relevant body is required to maintain under Article 130 of the credit institutions directive;

“prudential requirements regulation” means Regulation (EU) No 575/2013/EU of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms(**a**);

“recovery and resolution directive” means directive [ ] of the European Parliament and of the Council of [ ] establishing a framework for the recovery and resolution of credit institutions and investment firms;

“relevant body”, for the purposes of articles 5 to 9, means a relevant body which falls within article 4(2);

“resolution strategy” means any strategy prepared in relation to a relevant body by the Bank of England in planning for the possible exercise of its powers under Parts 1 to 3 of the Banking Act 2009 which—

(a) describes how the Bank proposes to use those powers in relation to that institution in the event that the powers become exercisable, and

(b) describes any arrangements (including any arrangements relating to the kind and amount of debt of the relevant institution) that, if made by the institution, would allow or facilitate the exercise of those powers by the Bank;

“risk-weighted exposure amounts” means the amounts calculated in accordance with Title II of Part 3 of the prudential requirements regulation for the purposes of Article 92(3)(a) or (f) of that regulation;

(**a**) OJ L 176, 27.6.2013, p1.

"total risk-weighted exposure" means the total of the risk-weighted exposure amounts;

"UK corporate authorised person" means an authorised person which is a body corporate incorporated in the United Kingdom;

"UK cumulative total debt requirement" means the sum of all debt requirements applied by the appropriate regulator to authorised persons, and to qualifying parent undertakings, in a single group;

"UK G-SIB" means a group which—

(a) is a G-SIB, and

(b) has its headquarters in the United Kingdom.

Debt requirement

2.—(1) Subject to paragraph (2), a "debt requirement" means a requirement to issue, or to maintain in issue, debt instruments creating or acknowledging liabilities of an amount specified by the regulator.

(2) A requirement to issue debt instruments which qualify as Additional Tier 1 instruments under Article 52 of the prudential requirements regulation, or as Tier 2 instruments under Article 63 of the prudential requirements regulation is not a debt requirement.

(3) For the purpose of this Order, the amount of a debt requirement refers to the amount of the liabilities which must be so created or acknowledged by debt instruments issued or maintained pursuant to the requirement.

Domestic systemically important institutions

3.—(1) The PRA shall apply the principles set out in the Basel Committee Framework to determine which banks or building societies should be considered to be domestic systemically important institutions because of the potential impact of their failure on the United Kingdom economy.

(2) The PRA shall publish a list of those banks and building societies it considers in accordance with paragraph (1) to be domestic systemically important institutions in such manner as it thinks fit once every twelve months.

Debt requirements: application

4.—(1) The appropriate regulator may only impose requirements on a relevant body within paragraph (2) in relation to the kind of debt instruments issued or to be issued by that body or the amount of debt to be created or acknowledged by such debt instruments in accordance with the conditions in articles 5 to 7.

(2) The relevant bodies referred to in paragraph (1) are—

(a) UK corporate authorised persons and qualifying parent undertakings which are a member of a UK G-SIB;

(b) a ring-fenced body, and

(c) any other relevant body which is a domestic systemically important institution.

(3) Nothing in this Order limits the appropriate regulator's power to impose debt requirements on any person which is not a relevant body within paragraph (2).

Requirements: relevant bodies

5.—(1) The requirements in this article apply subject to articles 6 and 7.

(2) Debt requirements may only require relevant bodies to issue or maintain in issue eligible debt instruments, or a class of eligible debt instruments.

(3) Subject to paragraph (5), where the aggregate amount of own funds maintained by a relevant body is equal to or greater than 17% of its total risk-weighted exposure, the appropriate regulator may not impose any additional debt requirements on that relevant body.

(4) Subject to paragraph (5), where the aggregate amount of own funds maintained by a relevant body is less than 17% of its total risk-weighted exposure, the amount of debt requirements which may be imposed on that relevant body by the appropriate regulator must not exceed a sum equal to X minus Y, where—

(a) X is 17% of the total risk-weighted exposure for the relevant body, and

(b) Y is the amount of own funds maintained by the relevant body.

(5) The appropriate regulator may impose higher debt requirements on a relevant body than would be permitted under paragraphs (3) and (4) where this is required to give effect to the resolution strategy for that relevant body.

(6) The appropriate regulator is not required to impose additional debt requirements on relevant bodies where the cumulative total of own funds maintained by relevant bodies in the group falls below the level it was when debt requirements were first imposed by the appropriate regulator on the relevant bodies, in accordance with this Order, if the appropriate regulator does not consider that it is appropriate to require those relevant bodies to hold additional debt.

(7) The appropriate regulator shall permit a relevant body to satisfy a debt requirement, or any part of a debt requirement, by issuing additional own funds, at the option of the relevant body.

(8) In setting debt requirements on relevant bodies the appropriate regulator shall—

(a) take account of the degree of risk the potential failure of a particular relevant body is perceived to pose to—

(i) the continuity of the provision in the United Kingdom of core services, or

(ii) the stability of the financial systems within the United Kingdom;

(b) take account of the resolution strategy for a relevant body as to the debt requirements which should be imposed on that relevant body.

Requirements: UK G-SIBs

6.—(1) Where the appropriate regulator is the competent authority responsible under Article 111 of the credit institutions directive for the exercise of supervision on a consolidated basis of some or all of the members of a group which is a UK G-SIB, it may only impose debt requirements on UK corporate authorised persons and qualifying parent undertakings in that group in accordance with paragraphs (2) to (8) below.

(2) Subject to paragraph (8), where the cumulative total of own funds maintained by relevant undertakings in the UK G-SIB is equal to or greater than the relevant percentage of the cumulative total risk-weighted exposure of those undertakings, no additional debt requirements may be placed on any UK corporate authorised person which is not a ring-fenced body or a domestic systemically important institution within that group.

(3) Subject to paragraph (8), and article 7, where the cumulative total of own funds maintained by relevant undertakings in the UK G-SIB is less than the relevant percentage of the cumulative total risk-weighted exposure of those undertakings, the appropriate regulator shall ensure that the amount of the UK cumulative total debt requirements set in relation to UK authorised persons and qualifying parent undertakings in that group is equal to the sum of X minus Y where—

(a) X is equal to the relevant percentage of the cumulative total risk-weighted exposure of the relevant undertakings in the group, and

(b) Y is the cumulative total of own funds maintained by relevant undertakings in the group.

(4) For the purposes of paragraph (3), the relevant percentage of the cumulative total risk-weighted exposure for relevant undertakings in a UK G-SIB shall be determined as follows—

(a) where the equity surcharge proposed for the UK G-SIB is 1% of its total risk-weighted exposure, the relevant percentage shall be 13.1% of the cumulative total risk-weighted exposure of the relevant undertakings;

(b) where the equity surcharge proposed for the UK G-SIB is 1.5% of its total risk-weighted exposure, the relevant percentage shall be 14.4% of the cumulative total risk-weighted exposure of the relevant undertakings;

(c) where the equity surcharge proposed for the UK G-SIB is 2% of total risk-weighted exposure, the relevant percentage shall be 15.7% of the cumulative total risk-weighted exposure of the relevant undertakings;

(d) where the equity surcharge proposed for the UK G-SIB is 2.5% or more of total risk-weighted exposure, the relevant percentage shall be 17% of the cumulative total risk-weighted exposure of the relevant undertakings.

(5) Subject to paragraph (6), for the purposes of paragraphs (2), (3) and (4) of this article, "relevant undertaking" means—

(a) companies incorporated in the UK which are members of the UK G-SIB,

(b) any other EEA companies which are members of the UK G-SIB.

(6) Where the resolution strategy prepared in relation to a bank which is a member of a UK G-SIB recommends that the risk-weighted exposures of some or all of the overseas subsidiary undertakings in that group are to be taken into account in setting the appropriate level of debt requirements to be imposed on UK corporate authorised persons, the relevant undertakings in the group for the purposes of paragraphs (2), (3) and (4) are—

(a) companies incorporated in the UK which are members of the UK-G-SIB,

(b) any other EEA companies which are members of the group, and

(c) those overseas subsidiary undertakings which are specified in the resolution strategy.

(7) The total debt requirements imposed by the appropriate regulator on UK corporate authorised persons and qualifying parent undertakings which are members of a UK G-SIB may not exceed the amount of eligible liabilities assessed as appropriate in the resolution strategies prepared for those authorised persons and parent undertakings.

(8) The appropriate regulator may impose higher debt requirements on authorised persons and qualifying parent undertakings than would be permitted under paragraphs (2) and (3) where this is required to give effect to the resolution strategy prepared in relation to authorised persons which are members of the group.

(9) The appropriate regulator is not required to impose additional debt requirements on authorised persons and qualifying parent undertakings where the cumulative total of own funds maintained by those undertakings falls below the level it was when debt requirements were first imposed by the appropriate regulator on authorised persons and qualifying parent undertakings, in accordance with this Order, if the appropriate regulator does not consider that it is appropriate to require those undertakings to hold additional debt.

Requirements: Ring-fenced bodies and domestic systemically important institutions

7.—(1) In determining what debt requirements should be imposed on a ring-fenced body or other domestic systemically important institution the appropriate regulator shall—

(a) apply the requirements set out in paragraphs (3), (4) and (5) of article 5, and

(b) take the following factors into account—

(i) the degree to which the body or institution concerned is considered to be systemically important to the United Kingdom, assessed in accordance with the principles set out in the Basel Committee Framework;

(ii) the amount of core deposits held in account with the body or institution concerned;

(iii) the aggregate of the amounts shown as assets on the balance sheet of that body or institution for the preceding financial year;

(iv) in the case of a domestic systemically important institution which is a member of a banking group which has its headquarters outside the United Kingdom, whether sufficient capital or debt requirements have been imposed on companies in that group by the regulator responsible for the supervision of the group to make provision for exposures held in the domestic systemically important institution in the United Kingdom; and

(v) any other factors which the appropriate regulator considers to be relevant.

(2) Where there is more than one ring-fenced body in a group, the sum of the debt requirements applied by the appropriate regulator to ring-fenced bodies in the group shall not exceed a sum equal to X minus Y, where—

(a) X is equal to 17% of the sum of the total risk-weighted exposures calculated for each ring-fenced body in the group, and

(b) Y is the sum of the own funds maintained by each ring-fenced body in the group.

(3) The total debt requirements imposed on a ring-fenced body or domestic systemically important institution may not exceed the amount of eligible liabilities assessed as appropriate in the resolution strategy prepared for that body.

(4) The appropriate regulator may impose debt requirements on a qualifying parent undertaking of a ring-fenced body or a domestic systemically important institution (the "subsidiary undertaking") set at an amount which includes the amount of debt requirements which it considers is appropriate in relation to the subsidiary undertaking (the "relevant amount") rather than imposing debt requirements of the relevant amount on the subsidiary undertaking, provided that—

(a) the qualifying parent undertaking is required to lend the relevant amount to the subsidiary undertaking in a form approved by the regulator, and

(b) the period for which the loan is made is the same as, or greater than, the period between the issue and maturity of the debt instruments issued by the parent undertaking to comply with those debt requirements.

Consultation

8. The appropriate regulator must consult the Treasury before imposing any debt requirement on a UK authorised person which is a relevant body specified within article 4(2).

Review

9. The appropriate regulator must review the amount of debt requirements it has imposed on a relevant body whenever any resolution strategy for that body is revised, and in any event at least once in every calendar year.

Name
Name
Date — Two of the Lords Commissioners of Her Majesty's Treasury

EXPLANATORY NOTE

(This note is not part of the Order)

This Order sets out the framework within which appropriate regulator (the Prudential Regulation Authority ("the PRA"), in relation to PRA-authorised persons or parent undertakings of authorised persons, and the Financial Conduct Authority ("the FCA") in other cases), must impose debt requirements on relevant bodies, that is, ring-fenced bodies, building societies, those bodies which are considered to be domestic systemically important institutions, and authorised persons which are members of global systemically important banks which have their headquarters in the UK.

Article 2 defines "debt requirement" for the purposes of the Order.

Article 3 requires the PRA to identify domestic systemically important institutions.

Article 4 identifies the relevant bodies which are within the scope of the Order, and requires the appropriate regulator to ensure that any debt requirements it imposes on such bodies comply with the provisions in the remainder of the Order.

Article 5 sets out the requirements to be observed by the appropriate regulator in relation to all relevant bodies, though these requirements are subject to the more detailed rules set out in articles 6 and 7.

Article 6 sets out the requirements governing the way in which the appropriate regulator are to impose debt requirements on authorised persons which are members of a global systemically important banking group which has its headquarters in the UK.

Article 7 sets out the requirements governing the way in which the appropriate regulator is to impose debt requirements on ring-fenced bodies and other domestic systemically important institutions.

Article 8 imposes an obligation on the appropriate regulator to consult the Treasury in relation to the imposition of debt requirements on relevant bodies.

Article 9 provides for the regular review by the appropriate regulator of the debt requirements it imposes on those relevant bodies within the scope of the Order.

"A Framework for dealing with domestic systemically important banks" published by the Basel Committee on Banking Supervision in October 2012, and "Global systemically important banks: assessment methodology and the additional loss absorbency requirement (rules text)" published in November 2011 can all be found on the website www.bis.org/bcbs/publications.htm (at www.bis.org/publ/bcbs233.htm, www.bis.org/publ/bcbs189.htm, and www.bis.org/publ/bcbs207.htm respectively). Copies of the Basel Committee documents may be obtained from the Bank for International Settlements, Communications, CH-4002 Basel, Switzerland (e-mail: publications@bis.org. The "Update of group of global systemically important banks" published by the Financial Stability Board on 1 November 2012 can be found on the website http://www.financialstabilityboard.org/publications/r_121031ac.pdf. A hard copy may be obtained from the Secretariat to the Financial Stability Board, Bank for International Settlements, Centralbahnplatz 2, CH-4002 Basel, Switzerland.

An Impact Assessment of the effect of the Financial Services (Banking Reform) Bill, and the secondary legislation to be made under it (including the Banking Reform (Loss Absorbency Requirements) Order 2013) on the costs of business and the voluntary sector has been prepared and is available on HM Treasury's website (www.gov.uk/treasury) or from the Banking Reform Bill Team, HM Treasury, 1 Horse Guards Road, London SW1A 2HQ and is annexed to the Explanatory Memorandum for this Order.

D Fees and Prescribed International Organisations Regulations

Draft Regulations laid before Parliament under section 429 of the Financial Services and Markets Act 2000, for approval by resolution of each House of Parliament.

D R A F T   S T A T U T O R Y   I N S T R U M E N T S

2013 No. xx

FINANCIAL SERVICES AND MARKETS

Financial Services and Markets Act 2000 (Fees and Prescribed International Organisations) Regulations 2013

Made - - - -	***
Coming into force - -	***

In accordance with section 429(2A) of the Financial Services and Markets Act 2000(**a**) a draft of these Regulations has been laid before and approved by a resolution of each House of Parliament.

The Treasury make the following Regulations in exercise of the powers conferred by sections 410A and 428(3) of the Financial Services and Markets Act 2000.

Citation, commencement and interpretation

1.—(1) These regulations may be cited as the Financial Services and Markets Act 2000 (Fees and Prescribed International Organisations) Regulations 2013.

(2) These regulations come into force on [ ].

(3) In these regulations—

"the Act" means the Financial Services and Markets Act 2000,

"affected class" has the meaning given in article 4(2).

Power to give directions

2.—(1) The Treasury may from time to time give a direction to a regulator requiring the regulator to require the payment of fees by relevant persons, or such class of relevant persons as may be specified in, or determined by the regulator in accordance with, the direction, for the purpose of meeting relevant expenses.

(2) A direction issued under paragraph (1) may be varied or revoked by a subsequent direction.

Treasury to consider affordability when making directions

3.—(1) Before giving a direction under regulation 2(1), the Treasury must consider whether the total amount intended to be raised by the fees to be charged by the regulator is affordable for—

(**a**) 2000 c. 8. Section 410A and section 429(2A) were inserted by sections 13 and 14, respectively, of the [Financial Services (Banking Reform) Act 2013].

(a) where the direction specifies a class of relevant persons who are to be required to pay fees, that class,

(b) where the direction requires the regulator to determine the class of relevant persons who are to be required to pay the fees, and contains criteria on which that class is to be determined, the relevant persons who may fall within the class of relevant persons determined by the regulator, and

(c) in all other cases, relevant persons.

(2) When considering affordability the Treasury must have regard to the views of the regulator to whom the direction is to be given.

Regulator to consider affordability when determining relevant persons

4.—(1) A regulator which is required, in accordance with a direction given to it under regulation 2, to determine the class of relevant persons to be required to pay the fees specified in the direction must consider whether the total amount intended to be raised by the fees is affordable for the affected class.

(2) In this regulation "affected class" means the class of relevant persons which the regulator determines are to be required to pay the fees specified in the direction mentioned in paragraph (1).

Regulators to impose fees by rules and pay fees to Treasury

5.—(1) Where a direction is given to the PRA or the FCA, the regulator to whom the direction is given must make rules providing for the charging of the fees specified in the direction.

(2) A regulator to whom a direction is given must 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.

Prescribed international organisations

6. The Financial Stability Board is prescribed for the purposes of section 410A(2) of the Act.

Scope of expenses chargeable as fees

7. For the purposes of section 410A(2) of the Act the following are regarded as expenses—

(a) subscription costs or membership fees for a prescribed international organisation, and

(b) capital contributions intended to fund a prescribed international organisation (including contributions intended to provide funding at a future time).

Name
Name
Date — Two of the Lords Commissioners of Her Majesty's Treasury

EXPLANATORY NOTE

(This note is not part of the Regulations)

These Regulations make provision in relation to the charging of certain expenses of the Treasury to relevant persons, namely specified PRA-authorised persons, authorised persons who are not PRA-authorised persons, recognised investment exchanges and recognised clearing houses. The expenses are those incurred in connection with United Kingdom membership of, or Treasury participation in, the Financial Stability Board (FSB).

Regulation 2 gives the Treasury power to issue directions to a regulator requiring them to levy fees against relevant persons for the purpose of meeting relevant expenses.

Regulation 3 requires the Treasury, before giving a direction to a regulator, to consider the affordability of the total amount intended to be raised by the fees charged by the regulator pursuant to the direction.

Regulation 4 requires a regulator, which is required to determine the class of relevant persons who will be required to pay fees specified in a direction given to it by the Treasury, to consider the affordability of the total amount intended to be recovered from that class of relevant persons.

Regulation 5 requires a regulator to whom a direction is given to pay any fees collected to the Treasury by the date or dates specified in the direction, and makes provision about how the PRA and the FCA are to comply with directions given to them.

Regulation 6 prescribes the Financial Stability Board (FSB) as an international organisation, in relation to which a fees direction can be given.

Regulation 7 specifies the kinds of expenses that can be included in a direction.

E Impact assessment

This annex contains the Government's impact assessment for the Financial Services (Banking Reform) Bill.

Title: Financial Services (Banking Reform) Bill **IA No:** HMT1302 **Lead department or agency:** HM Treasury **Other departments or agencies:** Department for Business, Innovation and Skills	**Impact Assessment (IA)** **Date:** 01/07/2013 **Stage:** Final **Source of intervention:** Domestic **Type of measure:** Primary legislation **Contact for enquiries:** Banking.commission@hmtreasury.gsi.gov.uk

Summary: Intervention and Options

RPC Opinion: GREEN

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**
£114,300m	£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 perceived 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 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 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?			No		
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:** N/A	**Non-traded:** N/A	

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) that the benefits justify the costs.

Signed by the responsible Minister: ______________ Date: 01/07/2013

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 Financial Services (Banking Reform) Bill

FULL ECONOMIC ASSESSMENT

Price Base Year 2013	PV Base Year 2019	Time Period Years 30	Net Benefit (Present Value (PV)) (£m)		
			Low: SEE TEXT	**High:** SEE TEXT	**Best Estimate: 114,300**

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low	500	2	420	**7,900**
High	1,750		1,950	**37,100**
Best Estimate	3,000		1,100	**20,900**

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

Direct private costs to UK banks: £1.7bn - £4.4bn 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% - 0.16% (equivalent to average annual GDP cost of £0.4bn - £1.9bn p.a.)
Indirect Exchequer impact: reduction in tax receipts of £150m - £690m p.a. and reduction of value of HMG shareholdings in RBS and Lloyds Banking Group of £1.6bn - £4.5bn, 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.
Direct cost to large UK banks of ensuring that ring-fenced banks are not liable for the pension liabilities of other members of their banking groups.

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		SEE TEXT	**SEE TEXT**
Best Estimate	SEE TEXT		7,100	**135,200**

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 (£7.1bn in 2011-12 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. Reducing implicit subsidies will also yield an efficiency gain from eliminating the distortion implicit subsidies represent.

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. This Impact Assessment (IA) is an updated version of the IA published at the introduction to Parliament of the Financial Services (Banking Reform) Bill ('the Bill') on 4 February 2013. It is being republished for the introduction of the Bill, as amended by the House of Commons, into the House of Lords and to accompany the publication for consultation of draft secondary legislation made under the powers in the Bill.
2. 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 through the Financial Services Act 2012, 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.
3. 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 Banking Reform Bill contains key measures to give effect to that commitment.
4. The 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.
5. The 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 will be exposed to losses ahead of retail depositors and the FSCS that protects them. These creditors will now have a greater incentive to curb excessive risk taking by banks. Some elements of the ICB's recommendations are not included in the 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 IA.
6. The measures in the Bill will serve to curtail the perceived implicit government guarantee to banks seen as 'too big to fail'. The 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 Bill. This IA sets out the estimated economic impact of the measures in the Bill.

Scope of this IA

Measures included in this IA

7. This IA covers the Government's implementation of the following ICB recommendations, which will be delivered through the Bill:
    - **Ring-fencing** of 'core' deposits - that is individuals and SME deposits - from 'excluded' wholesale banking activities.
    - **Preferring deposits** eligible for protection under the FSCS ('depositor preference').
    - Setting the **framework for the imposition of debt requirements** by the regulator on banks.

Measures not included in this IA

ICB recommendations not included in the Banking Reform Bill

8. The 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 (including by other domestic or EU legislation), and so are not included in the Bill. As they do not feature in the Bill, the impact of these measures is not included in this IA:
    - A **bail-in tool**: the Government expects bail-in to be implemented in the UK through transposition of the EU Recovery and Resolution Directive (RRD). The Government continues to work closely with EU partners to ensure that a credible and consistent bail-in 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 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).
9. 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 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]

Non-ICB policy measures in the Banking Reform Bill

10. In addition to the recommendations of the ICB listed above, the Banking Reform Bill will also impose new statutory duties on the FSCS and make provision for the statutory appointment of the Chief Executive of FSCS as an Accounting Officer. This measure does not require an impact assessment to be published as the only body affected by this is defined by the Office of National Statistics (ONS) as central Government.
11. In addition, the Bill gives HM Treasury power to direct the regulator by secondary legislation to impose fees to pay for the costs of the Government's participation in international financial stability fora. As the proposed fees fall within the classification of a tax, this provision is outside the scope of the regulatory impact assessment process.

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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 https://www.gov.uk/government/publications/banking-reform-delivering-sustainability-and-supporting-a-sustainable-economy

Description of options considered

Option 1: Baseline ('Do nothing')

12. It is important to isolate the incremental impact of the measures in the Bill from that of other regulatory changes related to financial services that are proceeding independently of the Bill. The Government has therefore constructed for this IA a 'do nothing' option in which none of the measures in the Bill are implemented, but in which wider regulatory changes go ahead, 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 Prudential Regulation Authority (PRA); and
    - Reform of the UK regulatory architecture through the Financial Services Act. [2]

13. This option will serve as a baseline for assessing the incremental impact of the measures in the Bill. For the purposes of this IA, the baseline option has zero costs and zero benefits relative to itself.

Option 2: Implement Banking Reform measures

14. <u>The Government's lead option is to proceed with the measures in the Banking Reform Bill and consequent secondary legislation</u>. These are:

    - <u>Ring-fencing</u>: the Bill implements the ICB's ring-fencing recommendation by creating 'core activities' (equivalent to 'mandated' activities in the ICB's terminology) and 'excluded activities' (equivalent to 'prohibited' activities in the ICB's terminology). The Bill provides that core activities may only be undertaken by ring-fenced banks (or by banks exempt from ring-fencing), and that ring-fenced banks may not carry on excluded activities.

      Core activities will be accepting deposits, apart from the deposits of large organisations and high net worth individual private banking customers, which may be held outside the ring-fence. Excluded or prohibited activities will be dealing in investments as principal, transacting with financial institutions and carrying on business outside the EEA, with exceptions to allow ring-fenced banks to manage their own risks prudently.[3]

      Ring-fencing will thus require that retail deposits are separated from wholesale/investment banking activities (except in banks below the *de minimis* exemption threshold). Ring-fenced banks will have to meet regulatory requirements (including on capital and liquidity) on a standalone basis, and be legally, economically and operationally independent of the rest of the wider corporate group. This will insulate core activities against shocks originating elsewhere in the global financial system and make it easier to preserve the continuity of those activities, while managing the failure of financial institutions in an orderly way, without injecting taxpayer funds.

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[2] More details on these regulatory reforms can be found at the following links:
<u>Basel III Capital Requirements, Globally Systemically Important Banks (G-SIB) Surcharge and Counter-Cyclical Buffer</u> - http://www.bis.org/publ/bcbs189.pdf and http://www.bis.org/publ/bcbs207.pdf
<u>PRA Liquidity Regulations</u> - http://www.fsa.gov.uk/pages/library/policy/policy/2009/09_16.shtml
<u>FPC Macroprudential Powers</u> – http://www.bankofengland.co.uk/financialstability/Pages/fpc/default.aspx
<u>The Financial Services Act</u> – https://www.gov.uk/government/policies/improving-regulation-of-the-financial-sector-to-protect-customers-and-the-economy

[3] For further details of the legislative mechanics of the Banking Reform Bill, see the Explanatory Notes published alongside the Bill. See Annex A below for more information on the regulatory assumptions made for the purposes of this IA.

The Bill will give the Treasury the power to make regulations requiring UK banks to separate their pension scheme liabilities such that a ring-fenced bank is not liable for the pension liabilities relating to other members of its group.

In line with the recommendation of the Parliamentary Commission on Banking Standards (PCBS), the Government has brought forward amendments to the Bill to provide for a reserve power to require an individual banking group to separate completely, including by divesting itself of its ring-fenced bank. Subject to approval by the Treasury, the regulator will be able to require full separation of an individual group if it is of the opinion that this is necessary to ensure the independence of the ring-fenced bank or the objectives of the ring-fence.

- **Preferring deposits** eligible for protection under the FSCS **('depositor preference'):** The Bill will provide that all deposits which are eligible for compensation under the FSCS ('insured deposits') are 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 depositors, the effect will be to 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.
- Setting the **framework for the imposition of debt requirements** by the regulator on banks. The Bill gives the Treasury a power to make an order regulating the way in which the regulator may exercise its powers under the Financial Services and Market Act 2000 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 in line with the ICB's recommendations.

  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.

Enabling nature of the Banking Reform Bill

15. The Bill is to some extent an enabling Bill, giving powers to HM Treasury to impose requirements on UK banks (for example specifying what activities may not be conducted by ring-fenced banks) by secondary legislation. The Government is publishing draft secondary legislation for consultation in July 2013. As the provisions of primary and secondary legislation and regulatory rules are interdependent, it is only possible to assess the impact of primary and secondary legislation as a single package.
16. This IA therefore applies both to the Banking Reform Bill for its introduction to the House of Lords, and to the draft secondary legislation being published for consultation. The IA assumes that the draft secondary legislation that is published for consultation is introduced in its current form (the Bill having received Royal Assent as introduced to the House of Lords). See Annex A below for detailed assumptions given to the major UK banks for modelling purposes.
17. The Bill also requires the regulators to make rules, for example establishing the restrictions on financial relationships between ring-fenced and non-ring-fenced banks necessary to achieve the degree of independence for ring-fenced banks specified in the Bill. For the purposes of estimating the costs and benefits of the Banking Reform measures, this IA assumes that the necessary rules are in place. When making rules, the regulators are required to publish rules in draft, with accompanying 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** incremental costs and benefits.
Option 2: Implement Banking Reform measures
Monetised costs (gross): Annual total private cost to UK banks: £1.7bn – £4.4bn; Reduction in long-run GDP level: 0.04% – 0.16%; (equivalent to average annual GDP cost of £0.4bn – £1.9bn); **Present Value GDP cost**: £7.9bn – £37.1bn; Reduction in annual tax receipts: £150m – £690m; Reduction in value Government shareholdings in Royal Bank of Scotland (RBS) and Lloyds Banking Group: £1.6bn - £4.5bn. **Monetised benefits (gross):** Illustrative increase in long-run GDP level from greater financial stability: 0.47%; (equivalent to annual GDP increase of £7.1bn in 2011-12 terms); **Illustrative Present Value GDP benefit**: £135bn. **Non-monetised benefits:** Improved resilience and resolvability of UK banks will, by curtailing perceived implicit government guarantees, 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.

18. All estimates in the table above are incremental to the 'Do nothing' baseline option described in paragraphs 12-13 above (which has zero costs and benefits relative to itself). The sections below discuss the costs and benefits of proceeding with the Bill measures.

Costs of option 2: Implement Banking Reform measures

19. The Government's estimates of the costs of implementing the ring-fencing and depositor preference 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

20. The first round cost impact of implementing the Banking Reform measures will be through an increase in the private costs of UK banks. The second round impact will be the impact on first GDP and then the Exchequer as a result of the increase in private costs to banks.

Private cost to UK banks

Curtailment of the perceived implicit government guarantee

21. The principal economic cost to UK banks of implementing the Banking Reform measures will arise from the curtailment 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]

22. 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

23. There will be some costs to banks from a reduction in the diversification of their activities, and thus a reduction in their ability to cross-subsidise or cross-sell services that end up on different sides of the ring-fence. The value of the benefit universal banks currently receive from diversification is, however, debated and the ICB struggled to quantify it. In addition to the cost of this loss of diversity, banks will face ongoing administrative costs of operating additional legal entities (such as the costs of operating separate IT platforms), and upfront costs of restructuring (such as the costs of establishing new subsidiaries).

Total cost to GDP (social cost)

24. In the first instance, an increase in banks' costs will have little or no impact on GDP as these costs to banks create benefits to other agents in the UK economy. For example, a rise in the cost of wholesale funding will represent an increase in a cost to banks, but also an increase in income to bank creditors. If there were no change in behaviour from this re-pricing of bank wholesale funding, there would be no change in GDP.

25. The impact on GDP materialises as banks, individuals and businesses change their behaviour in response to this transfer of costs. Faced with higher private costs, banks may pass through costs on to customers by increasing the price of credit they extend to individuals and businesses. This would act to increase the cost

[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

of servicing debt for households and the cost of capital for business, impacting household consumption and business investment, and hence GDP. Alternatively, banks may pass a portion of the cost onto shareholders (in lower returns) or employees (in lower pay). This could have an impact on GDP should the change in shareholder or employee income lead to a change in their consumption and investment behaviour.

26. The social cost is the most important cost for the purposes of the Government's cost/benefit analysis. This is because the benefits of greater financial stability (the objective of the policy) will be to the economy as a whole. For a discussion of the benefits of the measures in the Banking Reform Bill, see paragraphs 83-94 below. The appropriate comparison for cost/benefit analysis is therefore between the GDP cost and the GDP benefit of the Bill measures.

Cost to the Exchequer

27. The cost to the Exchequer is in two components: the impact on annual tax receipts, and the impact on the value of Government shareholdings in partially publicly-owned banks such as RBS and Lloyds Banking Group.

28. The impact on tax receipts flows from the cost to GDP. 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 annual 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

29. 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. The benefits of the policy option are discussed at paragraphs 83-94 below.

Private cost to UK banks

A. Summary of private cost to UK banks

30. The Government estimates that the total private cost to UK banks of the ring-fencing and depositor preference measures in the Bill will be in the range **£1.7bn - £4.4bn per year**, with one-off transitional costs in the range £0.5bn-£3bn. Establishing a framework for the imposition of debt requirements by the regulator will not in itself create any additional costs to UK banks.

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

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

B. Ring-fencing

I. Summary of private cost

32. The Government estimates that the aggregate private cost of ring-fencing to UK banks will be in the range £1.5bn-£4bn per year, with one-off transitional costs in the range £0.5bn-£3bn. This is slightly lower than the estimate included in the previous IA, as a result of banks' remodelling of the impact of Banking Reform measures on their businesses. See paragraphs 43-45 below.

II. Modelling the cost to UK banks of ring-fencing

33. The costs to banks of ring-fencing have been modelled in four components:

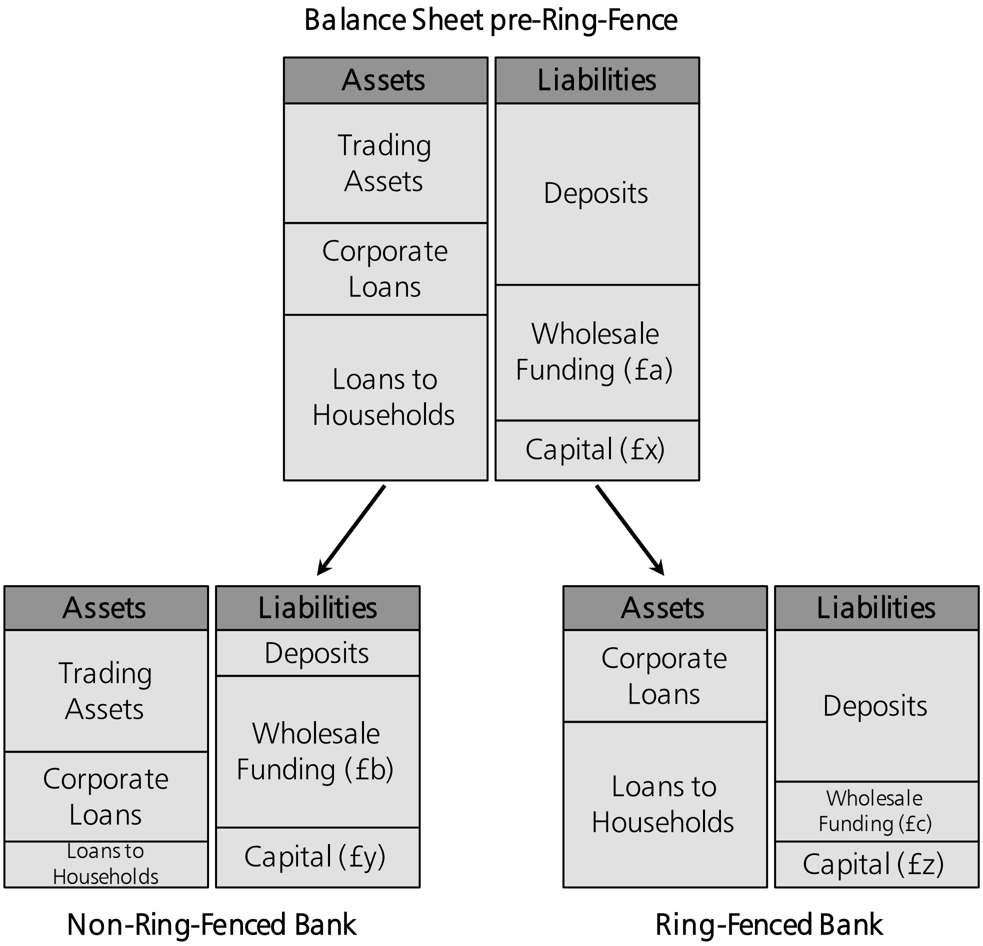
- **Capital Costs**: to meet separate capital requirements for ring-fenced and non-ring-fenced banks, banking groups may need to issue more capital in aggregate than in the baseline scenario, generating a gross ongoing cost (which may to some extent be offset by changes in funding cost).
- **Funding 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 if investors perceive non-ring-fenced banks as riskier and more volatile. Conversely, however, the funding cost of ring-fenced banks may fall, if 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.

34. 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 46-47 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. Since the publication of the previous IA, the Government asked the banks to refresh their modelling: this has resulted in some changes to the modelled impact: see paragraphs 43-45 below.

35. On the basis of the banks' 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 also modelled the incremental impact on their costs of funding of the Banking Reform measures, and estimated the transitional and ongoing operational costs. See Box 1 below for further explanation of the calculation of capital and funding costs.

Box 1: An illustration of the method for calculating the capital and funding costs

The Government asked the major affected banks to model their future balance sheets, first under a 'baseline' scenario, and then after a separation into ring-fenced and non-ring-fenced banks. This separation of assets and liabilities can be represented in the schematic diagram below:



(Diagram NOT drawn to scale)

Incremental capital cost

The incremental capital cost is calculated in two stages:

Change in quantity = (£y + £z) - £x

Capital cost = Change in quantity x cost of capital

The assumptions for the cost of capital are given in paragraph 48 below.

Incremental funding cost

The incremental wholesale funding cost can be conceived using the following equations:

Wholesale (w/s) funding cost = ((£b x cost of w/s funding$_b$) + (£c x cost of w/s funding$_c$)) – (£a x cost of w/s funding$_a$)

Where:

Cost of w/s funding$_b$ = cost of w/s funding$_a$ +(Non-ring-fenced bank spread)

Cost of w/s funding$_c$ = cost of w/s funding$_a$ + (Ring-fenced bank spread)

These equations take account of both the impact on overall funding costs of changes in the quantity and changes in the price of different classes of wholesale funding (including subordinated, senior unsecured and senior secured debt). Some banks modelled these two impacts sequentially, calculating first the quantity effect, based on changes to their balance sheets, and then the price effect, using a range of assumptions for the change in price, as discussed at paragraph 52 below.

36. 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.

37. 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	£1.3bn	£2.6bn
Funding	£70m	£890m
Operational	£150m	£530m
TOTAL ONGOING COST, per year	**£1.5bn**	**£4bn**
Transitional Cost (one-off)	£0.5bn	£3bn

III. Restructuring of bank pension schemes

38. To ensure the ring-fence is effective in curtailing the perceived implicit government guarantee of large UK banks, it is important to ensure the ring-fenced bank is economically independent of other entities in its banking group. In line with the ICB's recommendation and the *Banking Reform* white paper, the Government will require large UK banks to ensure that a ring-fenced bank is not liable for the pension liabilities relating to other members of its group. The Bill will give the Treasury the power to make regulations requiring UK banks to separate their pension scheme liabilities such that a ring-fenced bank is not liable for the pension liabilities of other members of its banking group.

39. It is important to note that the large UK banks affected are currently running deficits both on a "buyout" basis[6] and an ongoing funding "technical provisions" basis[7] which pre-date and are independent of the Government's ring-fencing proposals.

i. Options for restructuring of pension schemes

40. While requiring that ring-fenced banks should not be liable for the pension liabilities of other entities in its banking group, the Government intends to give as much flexibility to banks and their trustees to undertake this restructuring. The Government expects the banks and their trustees to determine the optimal solution for their respective schemes and to ensure that their pension scheme is restructured in a way that ensures the ring-fenced bank's economic independence. Given this flexibility, the details of the final outcome of how each scheme will be restructured cannot be predicted by the Government.

41. The two options the Government considers most likely to be undertaken by the banks to achieve this necessary restructuring are:

- "Splitting" a scheme - under this scenario, a second pension scheme is established with one or more employers having assets and liabilities transferred to it from the existing scheme in a way that extinguishes their liability to the existing scheme. This would remove the potential for liabilities of the non-ring-fenced bank to fall on the ring-fenced bank and vice versa.
- Segregation of a scheme - this is where a pension scheme is divided into two or more separate sections that cannot be used to cross-subsidise each other. Each employer will have liability only to a particular section of the scheme that has clearly identifiable assets and liabilities.

ii. Cost of separation

42. The Government believes there will be three principal costs of removing a ring-fenced bank's liability for the pension liabilities of other entities in its banking group:

- Initial separation cost - an employer withdrawing from a pension scheme, or a section of a scheme, is required to pay into the scheme compensation for giving up its previous liabilities to the scheme – known as the section 75 (s. 75) debt.[8] But if the departing employer takes with it some or all of its previous liabilities (into a new scheme or section), its s. 75 debt may be reduced by a 'relevant transfer deduction'. If the departing employer took its full share of the existing scheme's liabilities, the s. 75 payment is likely to be nominal. However, the exact level of the s. 75 payment would depend on details of how each pension scheme was restructured, and the resulting negotiation between banks and their trustees on the value of any payment required. Given the uncertainties involved, it is not possible for the Government to quantify the initial separation cost, so this cost has not been monetised in this IA.
- Ongoing impact on pension scheme covenant - the "employer covenant" is a term used to describe an employer's legal obligation to a pension scheme (or a section of a pension scheme) and its ability to fund the pension scheme now and in the future. The employer covenant is assessed by each scheme's trustees. The stronger the employer covenant, the more optimistic the trustees may be about the assumptions they make for future investment income from the assets of the scheme. A stronger covenant may therefore result in a lower scheme deficit to be funded by the employer.

  It is anticipated that employer covenants for each of ring-fenced and non-ring-fenced bank are likely to weaken after the corporate restructuring to separate the ring-fenced and the non-ring-fenced bank as each scheme, or section of a scheme, is now backed by fewer employers. In addition, the covenant may weaken as the claims on an insolvent bank of the bank's pension scheme to settle any s. 75 pension debts triggered by the bank's insolvency, become subordinated to FSCS-protected deposits (or to the FSCS standing in their place) in insolvency (see paragraphs

[6] The amount required to buyout a pension scheme's liabilities with an insurer

[7] The amount required to ensure that the scheme will be able to pay its liabilities over the longer term assuming returns on scheme assets.

[8] http://www.thepensionsregulator.gov.uk/guidance/multi-employer-schemes-and-employer-departures.aspx

59-62 below for the impact of depositor preference). To some extent these effects are likely to be offset by the improved resilience of the banks following implementation of the Banking Reform measures. For example, ring-fenced banks will be better capitalised and insulated against global market shocks: this should reduce the probability of their becoming insolvent, which (all else equal) would increase the strength of the employer covenant.

How far the covenant is affected will however depend on the exact details of how each scheme is restructured, which cannot be predicted in advance. In addition, the extent to which a weakening of the covenant will lead to higher costs to banks is dependent upon the negotiation between banks and their trustees, which is uncertain. Given this uncertainty, it is not possible for the Government to model these costs and so they have not been monetised in this IA.

- Administrative cost - there will be one-off costs associated with the segregating or splitting of the liabilities to the pension scheme, including costs such as legal, actuarial and administration fees. Estimates provided by the large UK banks and the trustees of their pension schemes suggest this impact would be no greater than £50m across all the affected banks in relation to the ring-fencing of the pension liabilities.

IV. Assumptions, risks and sensitivities: Ring-fencing

i. Refresh of banks' modelling

43. Since the publication of the previous Banking Reform IA on 4 February 2013, the Government asked the major UK banks to refresh their modelling of the impact of the Banking Reform measures on their businesses. This has allowed the banks to update their cost estimates in the light of more recent assumptions about the macroeconomy and their wider business strategy, and of further detail on the calibration of regulatory requirements, for example from the publication of the Banking Reform Bill itself.

44. This refresh of banks' modelling has yielded an estimated aggregate private cost of the Banking Reform measures that is slightly lower than that included in the previous IA, though still of a comparable scale overall.

45. The reduction in banks' estimates of the cost to their businesses may be the result of a number of factors. To some extent changes in market conditions (for example a reduction in wholesale funding market stress since 2012) or in the macroeconomy will have affected banks' modelling of both baseline and post-Banking Reform scenarios. Changes in banks' business strategies may also have had an impact. For example, some banks have announced a greater focus on their core retail and commercial businesses or a reduced reliance on wholesale funding: such changes could reduce the modelled incremental cost of implementing ring-fencing and depositor preference. Where these changes in business models were primarily anticipating implementation of the Banking Reform measures, banks' modelling may understate the private costs of those measures (as some costs will have been crystallised in banks' baselines). However, if business model changes were driven by other factors, such as wider market conditions, the impact of other regulatory reforms or different strategic choices made by bank managements, then these other factors will have mitigated the incremental costs of Banking Reform.

ii. Ring-fencing requirements determined by secondary legislation and regulatory rules

46. As noted above (paragraphs 15-17), this IA assumes that secondary legislation will be made in line with the draft secondary legislation published for consultation in July 2013. For the purposes of their modelling, the banks needed to make certain assumptions about the content of that secondary legislation before drafts were available. To make this possible, the Government supplied the banks with a set of assumptions about the provisions of the secondary legislation: these assumptions are listed at Annex A below. In some cases, banks were unable to use prescribed assumptions (for example because banks do not currently collect the data necessary to measure their compliance with some provisions of the secondary legislation), so had to use their own assumptions or definitions. However, the Government believes that the banks' modelling assumptions broadly reflect the intentions of the secondary legislation, and that the effect on modelling results of applying the exact provisions of the draft secondary legislation instead would be relatively minor.

47. The banks also needed to make assumptions about the content of regulatory rules. Here, the Government asked them to assume that rules were made such as to ensure the outcomes prescribed in the Bill, for example on the degree of independence of a ring-fenced bank from the rest of its corporate group.

iii. Equity capital assumptions

48. 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[9] to banks of 11.5 per cent, calculated by the Prudential Regulation Authority (PRA).[10]

49. 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 £16.4bn. 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.

50. To reflect the likelihood that bank managements would in practice operate a little above regulatory minimum capital requirements, the Government asked the banks to assume a management buffer of 1% of risk-weight assets (RWAs) above the regulatory minimum core equity (CET1) requirement, and a management buffer of 2% of RWAs above their regulatory minimum Primary Loss-Absorbing Capacity (PLAC) requirement.

iv. Wholesale funding cost assumptions

51. The impact of ring-fencing on banks' funding costs is difficult to forecast precisely. The reduction in the perceived implicit government guarantee should result in an increase in the price of bank funding. Among banks, as discussed in paragraph 33 above, it is likely that ring-fencing will increase the cost of funding for non-ring-fenced banks, to reflect their greater revenue volatility, while both ring-fenced and non-ring-fenced banks may see a further increase in funding costs as a result of reduced revenue diversification. 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: a reduction in banks' wholesale funding requirements (for example as a result of increasing their capital levels) would to some extent offset the impact of higher funding prices.

52. For their modelling of the impact of ring-fencing, the banks typically assumed that the price of debt issued by ring-fenced banks would remain the same, and used a range of assumptions about the change in the price of different classes of debt issued by non-ring-fenced banks. The Government drew on these to produce high and low assumptions for the impact on banks' costs of wholesale debt, summarised in the table below. The Government applied the highest and lowest of these assumptions to each bank to estimate the aggregate incremental funding cost.

Class of Funding	Change in price, bps	
	LOW	HIGH
Subordinated Debt	+75bps	+150bps
Long-Term Senior Unsecured Debt	+25bps	+100bps

53. It is important to note that these estimated impacts on banks' funding costs <u>do not include the impact of bail-in</u>. This is because the Bill does not include provision for a bail-in tool: as noted in paragraph 8 above, it is expected that bail-in will be implemented via transposition of the European RRD. This is one area of

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[9] Rather than the opportunity cost of equity over debt.

[10] Formerly the Financial Services Authority (FSA). 'Strengthening Capital Standards 3 - further consultation on CRD3', FSA consultation paper CP11/09

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.[11]

v. <u>Reserve power to require full separation</u>

54. In line with the recommendation of the PCBS, the Government has amended the Bill in the House of Commons to provide for a reserve power for the regulator, with the consent of the Treasury, to require an individual banking group to separate completely its retail and wholesale activities, if this is necessary to ensure the independence of the ring-fenced bank.

55. Imposing a requirement for complete separation would carry substantial costs for the individual group concerned, both in the short term from executing the separation and in the longer term from the restrictions on the group's business model that complete separation would involve. The Government expects that the prospect of these costs would provide a powerful incentive for groups to ensure that their ring-fenced banks are independent of the wider group and that they do not engage in conduct likely to undermine the continuity of core services in the UK. Thus even if no group is actually required to separate, the reserve power will serve to reinforce the ring-fence. For the purposes of this IA, banks were asked to assume a robust ring-fence, with ring-fenced banks independent of the rest of their groups in accordance with the principles set out in the Bill. The banks' modelling thus already captures the ongoing deterrent effect of the reserve power, so the addition of the reserve power does not generate an additional cost.

vi. <u>Operational costs and tax implications</u>

56. 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 £30m - £105m per bank per year. Costs are likely to vary depending on banks' business models, including their choices over the location of the ring-fence and of operational services such as data centres and other IT infrastructure.

57. 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. The costs arising from tax policy are out of scope of this IA any case, as this assesses only the costs and benefits of regulation not tax.

vii. <u>Transitional costs</u>

58. Some restructuring will be required in order for banks to comply with the ring-fence. This will involve some up-front cost, though it should be noted that banks may already be required to carry out some restructuring in order to meet the requirements of resolution plans drawn up by the resolution authorities. The incremental costs of restructuring to comply with ring-fencing will vary from bank to bank. On the basis of estimates provided by the banks, the Government has assumed a restructuring cost per bank in the range of £100m-£600m.

C. <u>Depositor preference</u>

I. Summary of private cost

59. The Government estimates that the aggregate private cost of depositor preference to UK banks will be in the range <u>£200m-£380m per year</u>.

II. Modelling the private cost of depositor preference

60. 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

[11] 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 https://www.gov.uk/government/publications/banking-reform-delivering-sustainability-and-supporting-a-sustainable-economy

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 to reflect the higher expected loss for senior unsecured creditors in the event of a bank failing.

61. The Government asked the major UK banks to include preference for FSCS-protected deposits in their modelling of the impact of the Banking Reform measures. The banks produced a range of estimates for the impact of the higher expected loss on the price of wholesale funding, up to an increase of 100bps in the cost of senior unsecured debt. The banks noted, however, that this higher expected loss would be the result not just of depositor preference, but also of other measures to ensure that losses can fall on banks' wholesale creditors in the event of failure, in particular bail-in. As noted above, the Bill does not include bail-in, which the Government expects will be delivered through European legislation (the EU Recovery and Resolution Directive (RRD)): the costs and benefits of bail-in are therefore outside the scope of this IA.

62. Although isolating the funding cost impact of depositor preference from that of bail-in is difficult, it is therefore likely that the banks' estimates overstate the impact of depositor preference. For the purposes of this IA, the Government has therefore used an assumed range for the impact of depositor preference on the cost of wholesale funding, of 25bps to 50bps.

D. <u>Framework for imposition of debt requirements</u>

I. Summary of private cost

63. The ICB recommended that large banks be required to maintain Primary Loss-Absorbing Capacity (PLAC) of at least 17 per cent of RWAs, consisting of regulatory capital plus debt that is clearly subject to bail-in.[12] 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 require 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.

64. The 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).

II. Assumptions, risks and sensitivities: Framework for debt requirements

i. <u>Regulatory assumptions on loss-absorbency</u>

65. 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, imposed under European legislation (CRD IV, CRR, RRD). 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' above this minimum). More detail on the assumptions for loss-absorbency is included in Annex A below.

E. <u>General assumptions for modelling private cost to banks</u>

<u>Static modelling of bank balance sheets</u>

66. 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

[12] 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.

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).

67. 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.

Crisis response and stress

68. For the purposes of this IA, modelling has focussed exclusively on the long-run costs of the measures in the 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.

69. 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

70. On the basis of banks' refreshed modelling of the impact of the Banking Reform measures on their businesses, the increase in private costs is estimated to produce a gross[13] **reduction in the long-run level of GDP in the range 0.04% to 0.16%**, equivalent to an average[14] annual cost to GDP of **£0.4bn - £1.9bn** relative to the 'regulatory environment' baseline scenario. The present value cost to GDP is estimated at £7.9bn - £37.1bn. There is an increase in uncertainty in the estimate with a somewhat higher bound compared with that included in the previous IA. The range has broadened due to the particularities of the model used among other factors including interactions between changes to different elements of the overall cost within banks' refreshed balance sheet modelling. As discussed in paragraphs 43-45 above, changes in banks' refreshed balance sheet modelling may reflect both changes in external market conditions, and changes in banks' own commercial strategies.

Modelling the cost to GDP

71. Having estimated the aggregate private cost to UK banks of implementing the measures in the Bill, the Government then estimated the impact of these costs on GDP from modelling by the PRA using the NiGEM model. NiGEM is an empirically-based econometric model that estimates the impact on economic output as a result of changes to banks' minimum capital ratios, funding and operational costs. The model uses long-run historical data that capture the various channels (e.g. changes in the consumption behaviour of economic agents such as bank customers or bank shareholders) through which changes to bank private costs transmit to changes in GDP. Paragraphs 24-26 above describe how the GDP cost arises in more detail.

Assumptions, risks and sensitivities

NiGEM modelling of long-run GDP cost

72. NiGEM calculates the GDP cost on the assumption that banks pass on to consumers near to 100% of the additional private costs to banks, reflecting the historical data that underpins the model. This suggests that little, if any, private costs will directly transmit to banks' profits.[15] 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.

73. The key inputs to the NiGEM model are the changes in banks' capital ratios and incremental funding, operational and transitional costs. NiGEM models the impact of changes to these variables on a forecast GDP path: for these purposes, the following assumptions were made about the timescales over which the different bank costs were incurred:

- capital ratios 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, capital ratios remain constant;
- funding costs increase steadily year on year over the transition period until 2019, after which they are constant year on year;
- transitional costs are incurred in the first two years of the transition period of the policy; and
- operational ongoing costs are zero in the first two years, but are then constant each year thereafter.

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[13] i.e. not taking account of the benefits to GDP of the measures in the Bill.

[14] Over a 30-year forecast period: see 'Calculating present value of GDP cost' section.

[15] Though there could be a second-round indirect impact on bank profits to the extent that higher prices reduce demand for banks' products.

Calculating present value of GDP cost

74. The NiGEM modelling estimates the impact on the long-run level of GDP of the Banking Reform measures, and the average annual GDP cost. This average annual cost has then been used to calculate the present value cost to GDP for the purposes of this IA. The Government's intention is for the measures in the Bill to constitute a permanent reform to the banking sector. For the purpose of calculating the present value GDP cost and benefit, the annual GDP costs and benefits have been assumed to persist for 30 years, discounted according to HM Treasury Green Book guidance. 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.

Short-run GDP impact

75. 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 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, in particular higher capital requirements, by shrinking their balance sheets and cutting back lending to the real economy to meet the capital requirements. 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]

76. The Government has established 2019 as the final deadline for compliance with ring-fencing, in line with the ICB's recommendations. This will give UK banks several years in which to raise the additional capital required (as well as to implement the necessary restructuring). As noted in paragraph 49 above, UK banks will have a range of options for raising additional capital. The Government therefore believes that the extended timetable for compliance proposed by the ICB will mitigate the risks of banks deleveraging significantly in the short term in response to the new regulations.

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

Cost to the Exchequer

Summary of Exchequer cost

77. Implementing the measures in the Bill is estimated to produce a gross **reduction in tax receipts of £150m-£690m per year** and a **reduction in the value of the Government's shareholdings in partially publicly-owned banks of £1.6bn - £4.5bn**, relative to the 'do nothing' baseline. The range for the estimated reduction tax receipts has broadened with a higher upper bound since the previous IA, reflecting the increase in range for the estimated GDP cost. The impact on the value of Government shareholdings has slightly decreased: see paragraphs 80-82 below.

Tax receipts

78. 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 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-£690m per year.

79. 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 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

80. The additional costs of the measures in the 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. However, with markets already anticipating that the Banking Reform measures will be implemented, it is likely that the impact is already largely or entirely factored into the two banks' current market share prices.

81. On the basis of the impact modelling supplied by the two banks, UK Financial Investments Ltd (UKFI) applied standard bank valuation methods to estimate the potential loss to the value of the Government's shareholding in RBS and Lloyds from proceeding with the Banking Reform measures. These estimates are not of the value impact relative to today's prices: rather, they compare the projected value of the Government shareholdings with a counterfactual future scenario in which none of the Banking Reform measures are implemented. Key inputs to this modelling are the impact on the banks' return on equity (based on the banks' own modelling and estimates of changes to their funding and operating costs) and the assumed cost of equity. As with the other cost estimates for this IA, no account was taken of behavioural responses, and the impact of bail-in was not included. Unlike the modelling of GDP impact for this IA, however, these value impact estimates do not assume any pass-through of banks' costs to customers: this may lead to some double-counting of costs. Given these caveats, the UKFI estimates should be viewed as broadly indicative of the maximum extent of shareholder costs, rather than precise forecasts.

82. Applying these assumptions and methods gives an estimated reduction in the value of the Government shareholdings of £1.6bn - £4.5bn. This is slightly lower than the estimated for previous

IAs on the Banking Reform measures, and reflects the two banks' refreshed modelling of the private cost of the Banking Reform measures on their businesses. As discussed in paragraphs 43-45 above, to some extent the banks' lower estimates of the private cost may reflect changes in external market conditions. Lower estimated private costs may also be the result of changes in the banks' strategies, for example the increased focus by RBS on its core UK retail and commercial business that has been announced since early 2012. To the extent that such changes have been driven primarily by anticipation of the Banking Reform measures, some of the value impact may have been already crystallised in the banks' baseline projections. But where changes in business strategy have been driven by other factors, the response to these other factors will have mitigated the impact of the Banking Reform measures.

Benefits of option 2: Proceed with Banking Reform Bill

Economic benefits of increased financial stability

83. The aim of the 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. Curtailing the perceived implicit guarantee should bring a benefit to the Government's borrowing costs, as sovereign debt investors perceive a reduction in the Government's contingent liability to the banking sector (that is, a reduced likelihood of the Government needing to use public funds to support failing banks in a future financial crisis).

84. The measures in the 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). This should therefore make banking crises less frequent and less costly to the economy in the future, resulting 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.

Challenges in quantifying the benefits of increased financial stability

85. 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. In its final report, the ICB quoted a survey of academic estimates of the annual GDP cost of financial crises compiled by the Basel Committee on Banking Supervision (BCBS). According to the figures in this academic literature, the maximum range for the annual GDP cost is very wide, from 0.58 to 15.7 per cent of GDP.[17] It is, however, clear that systemic financial crises can be extremely costly when they do occur, both to GDP and to the public finances. Drawing average values from the academic literature surveyed by the BCBS, the ICB estimated the annual cost of financial crises at approximately 3 per cent of GDP, or around £40bn in 2010 terms.[18]

86. The experience of the 2008-09 financial crisis further illustrates how large the costs of financial instability can be. According to the Office for National Statistics (ONS), the crisis of 2008-09 led to a peak-to-trough fall in GDP of 7.2 per cent,[19] and the Office for Budget Responsibility (OBR) forecast that potential output in 2017 will be 14.6 per cent below an extrapolation of its pre-crisis trend, with actual output a further 2.3 per cent below that.[20] 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.[21]

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[17] ICB *Final Report*, paragraph 5.8. The ICB quoted BCBS 2010, *An Assessment of the Long-term Economic Impact of Stronger Capital and Liquidity Requirements*. In the literature surveyed by the BCBS, estimates of the probability of a financial crisis occurring in a given year ranged from 3.6 to 5.2 per cent, and estimates of the net present value cost to GDP of a crisis occurring ranged from 16 to 302 per cent. Multiplying lowest by lowest and highest and highest gives a maximum range for the annual cost to GDP ranging from 0.58 to 15.7 per cent of GDP.

[18] ICB *Final Report*, paragraph 5.8 and 5.67. From the literature surveyed by the BCBS, the ICB drew average values for the probability of crises in a given year (4.5 per cent) and the net present value output cost of a crisis occurring (63 per cent). Multiplying these gives an estimated annual cost of 2.8 per cent.

[19] *Quarterly National Accounts, Q12013*, ONS June 2013.

[20] *Economic and Fiscal Outlook*, OBR March 2013.

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

Illustrative calculations of benefits of improved financial stability

87. 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.

88. Using the ICB's method for quantifying the annual GDP cost of financial crises, it is possible to show the scale of the benefits to GDP that a reduced likelihood or output cost of financial crises (that is an increase in financial stability) would bring. An illustrative calculation of this sort was included in the IA accompanying the June 2012 *Banking Reform* white paper.

89. This calculation began with the ICB's estimate of the annual cost of financial crises. It first assumed that wider regulatory reforms (such as those included in the 'do nothing' baseline option) would reduce this annual cost by 30 per cent. From this baseline, if implementing the ICB's recommendations further reduced the probability of future 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 £9.8bn in 2011-12 GDP terms.

90. This illustrative calculation can be adjusted to reflect the exclusion from this IA of those elements of the ICB's recommendations not included in the Bill (for example bail-in). Assuming the same baseline estimates for the starting GDP cost of financial crises and for the impact of baseline regulatory changes, if the measures in the 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 £7.1bn in 2011-12 GDP terms.

Sensitivity analysis for illustrative calculation

91. An illustrative calculation of this sort is naturally sensitive to the assumptions used. A particular sensitivity is to the value used in the starting estimate of the annual GDP cost of crises for the present value GDP cost of a crisis when one does occur. If, instead of the average value calculated by the ICB (63 per cent), the maximum value included in the academic literature (302 per cent) is used, the annual cost of crises calculated using the ICB's method rises to 14 per cent of GDP. If the cost of crises is higher, then so will be the benefit of greater stability: if this higher starting cost of crises is used as an input to the illustrative calculation described in paragraph 89 above, the incremental annual benefit of the measures in the Banking Reform Bill rises to 2.2 per cent of GDP, or £34bn in 2011-12 GDP terms.

92. Conversely, if the lowest value in the academic literature for the present value cost of a crisis (16 per cent of GDP) is used in the same illustrative calculation, the incremental annual benefit of the Bill measures falls to 0.12 per cent of GDP, or £1.8bn in 2011-12 GDP terms.

93. The illustrative calculation is also somewhat 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 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 Bill measures by around 0.01 percentage points or £100m in 2011-12 GDP terms. If the baseline reforms assumption is held constant, then each 1 percentage point change in the impact of the 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 (£260m and £270m in 2011-12 GDP terms), respectively.

94. Despite this sensitivity to assumptions, it is clear that given the very large scale of the costs to the economy of financial crises, even relatively modest increases in financial stability can yield significant benefits to GDP. To illustrate this further, it is possible to calculate the least impact on financial stability that the measures in the Banking Reform Bill need have for them still to yield a net benefit to GDP. Assuming the same starting cost of crises and impact of baseline regulatory reforms as used in paragraph 90 above, in order to produce an incremental benefit to GDP of 0.16 per cent (the upper end of the estimated range of GDP costs), the

measures in the Bill need only reduce the probability of future crises by 4 per cent and their GDP impact by 4 per cent.

Conclusion on costs and benefits of Banking Reform Bill

95. Given the measures in the Bill are intended to reduce the probability and severity of future financial crises, and that such crises are very costly the UK economy, 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 (option 1).

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

Proportionality

96. 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).

97. 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 Bill, which have been compared to a 'do nothing' alternative.

Wider impacts

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

Impact on competition in the UK banking sector

99. 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

100. The aggregate private costs to the banking industry are £1.7bn–£4.4bn. 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

101. 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

102. 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 that 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

103. 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

104. Enforcing and policing the ring fence will incur costs to the Prudential Regulation Authority (PRA). The PRA 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 Bill will likely be somewhat lower.

Equality impact

105. 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.

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

Exemption from One-in-One-out rule

107. The measures the Government is introducing through the Banking Reform Bill deal with the issue of financial systemic risk. As noted above in the 'Introduction', the measures in the Bill will make UK banks and the UK banking sector as whole more resilient to shocks (reducing the likelihood of bank failure) and more easily resolvable in the event of failure (reducing the impact on the financial sector, the public finances and thus the economy). The measures specifically intend to reduce systemic risk in the UK banking sector by increasing UK financial stability. There is an exemption for measures dealing with systemic financial risk from the Better Regulation Executive's One-in-One-Out Rule, [22] so the measures in this IA are therefore out of scope of the rule.

EU Minimum Requirements

108. The Government considers that the ring-fencing and depositor preference policy measures do not go beyond minimum requirement of existing EU law as there is currently no EU legislation in force concerning the separation of retail from wholesale banking activities or legislation to prefer bank depositors in the case of bank insolvency. The Government does however recognise the current and ongoing discussions concerning these policy areas at an EU level, for example the recently published Liikanen report on structural reforms.

109. In addition, the Banking Reform Bill does not set out minimum requirements for banks' regulatory capital or PLAC. As outlined in Annex A, the Government has made modelling assumptions for minimum regulatory capital and PLAC requirements. In some cases however, the modelling assumptions used may go beyond the assumed EU minima.[23] The modelling assumptions have been made in line with Government policy that was set out in the *Banking Reform* white paper, but are not measures included in the Banking Reform Bill.

Summary and implementation plan

Chosen policy option

110. The Government therefore proposes to implement the measures in the Bill (Option 2). The Government believes that implementing these measures will deliver net benefits relative to the baseline (Option 1).

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[22] http://www.bis.gov.uk/assets/biscore/better-regulation/docs/o/11-671-one-in-one-out-methodology.pdf

[23] CRDIV and RRD address these minimum requirements for the EU, which at the time of publication, had not be finalised.

Implementation plan

111. The Banking Reform Bill has now completed its passage through the House of Commons and has been introduced into the House of Lords. Once the Bill has received Royal Assent, secondary legislation can be introduced to Parliament and the regulators can begin making rules.

112. Further impact assessment will accompany the secondary legislation at its introduction. When making rules, the regulators are also required to publish rules in draft, with accompanying cost-benefit analysis.

Annex A

Assumptions on secondary legislation and regulatory rules

Listed below are the assumptions the Government gave to the major UK banks for the purpose of their modelling of the impact on their businesses of the Banking Reform measures. The assumptions below do not necessarily reflect the Government's final position in these areas. The Government will consult on secondary legislation, and the regulators are required to publish rules in draft.

Ring-fencing:

Issue	Modelling assumption for this IA
De minimis exemption from ring-fencing	Banks with core deposits of less than £25bn exempt from ring-fencing.
Core ('mandated') Services	Accepting deposits (except from non-SME organisations and high net worth individual (HNWI) private banking customers) is the only core activity (i.e. may only be carried out by Ring-fenced banks (RFBs) or banks exempt from ring-fencing).
Definition of SME	Banks to use own definitions
Definition of HNWI private banking customer	Banks to use own definitions
Excluded ('prohibited') Services	RFBs prohibited from dealing in investments as principal, entering into derivatives contracts, or underwriting securities issues. RFBs prohibited from having exposures to financial institutions, other than for the purposes of managing RFBs' own risks, provision of payments services or provision of trade finance. RFBs prohibited from having branches or subsidiaries outside the EEA.
Permitted Services	Permitted services are those that are not 'core' or 'excluded' as defined by the Bill, and may be undertaken by either ring-fenced or non-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 (derivative) to customers. Banks to use own definitions for 'simple' derivatives.
Status of Crown Dependencies	Treat Crown Dependencies as if within the EEA for the purposes of permitted branches and subsidiaries.
Solo capital and liquidity requirements for RFB	RFB to meet regulatory capital and liquidity requirements on a solo basis.
Intra-group relationships	RFB to be economically and operationally independent of the rest of its group, in accordance with the principles set out in s.142H of the Banking Reform Bill. In particular, intra-group transactions to be conducted on a third-party basis; and RFBs to have independent governance, risk management, human resources and remuneration policies as required under s.142H of the Banking Reform Bill.
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.

Loss-absorbency:

Issue	Modelling assumption for this IA
Regulatory capital and PLAC requirements: general	RFBs to meet regulatory minimum capital and PLAC requirements on a solo basis. Banks free to meet capital or PLAC requirements using higher-quality instruments if they choose (e.g. meeting total capital requirement with CET1 only; meeting PLAC requirement using regulatory capital only).
Regulatory capital requirements: RFBs	Minimum Common Equity Tier 1 (CET1): 11% RWAs *(=4.5% Basel III minimum; plus 2.5% Basel III capital conservation buffer; plus 3% Ring-Fence Buffer; plus 1% management buffer)* Minimum Tier 1: 12.5% RWAs *(=11% CET1 plus 1.5% Alternative Tier 1 (AT1) capital)* Minimum Regulatory Capital: 14.5% RWAs *(=12.5% Tier 1 plus 2% Tier 2 capital)* Minimum Tier 1 Leverage Ratio: 3% Total Exposures.
Regulatory capital requirements: non-RFBs	Minimum Common Equity Tier 1 (CET1): 10.5% RWAs *(=4.5% Basel III minimum; plus 2.5% Basel III capital conservation buffer; plus 2.5% G-SIB surcharge; plus 1% management buffer)* Minimum Tier 1: 12% RWAs *(=10.5% CET1 plus 1.5% Alternative Tier 1 (AT1) capital)* Minimum Regulatory Capital: 14% RWAs *(=12% Tier 1 plus 2% Tier 2 capital)* Minimum Tier 1 Leverage Ratio: 3% Total Exposures.
PLAC Requirement: RFBs and non-RFBs	Minimum Primary Loss-Absorbing Capacity (PLAC): 19% RWAs *(=17% regulatory minimum; plus 2% management buffer)*
Instruments Eligible to meet PLAC requirement	Regulatory Capital, plus long-term (=term greater than 1 year) senior unsecured bonds.
Group-level PLAC for UK headquartered G-SIBs	Group-level PLAC requirement to apply to all group RWAs where groups assume a 'single point of entry' (SPE) resolution strategies. Group-level PLAC requirement excludes non-EEA entities where groups assume a credible 'multiple point of entry' (MPE) resolution strategies.

F

Regulatory Policy Committee certificate

This annex contains the Regulatory Policy Committee's certificate confirming the Government's impact assessment is fit for purpose.

Regulatory Policy Committee	**OPINION**
Impact Assessment (IA)	Financial Services (Banking Reform) Bill
Lead Department/Agency	HM Treasury
Stage	Final
Origin	Domestic
IA Number	Not provided
Date submitted to RPC	09/01/2013
RPC Opinion date and reference	21/01/2013 RPC12-HMT-1665
Overall Assessment	**GREEN**

Overall comments on the robustness of the OIOO assessment

The IA is fit for purpose. The IA states that this proposal deals with financial systemic risk as it will make UK banks and the UK banking sector more resilient to shocks and the economic effects more easily resolvable in the event of failure. This appears a reasonable assessment in accordance with the current One-in, One-out Methodology (paragraph 16 xiv). This proposal is therefore out of scope of 'One-in, One-out'.

Overall quality of the analysis and evidence presented in the IA

Whilst the majority of the impacts of the policy have been monetised the IA does not include an estimate of the cost to business of restructuring pension schemes. The total costs of restructuring pension schemes are highly uncertain.

The IA would have benefited from containing a discussion of the alternative options considered by the Independent Commission on Banking for strengthening financial services regulation.

Signed **Michael Gibbons,** Chairman

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