HM Treasury

Banking reform draft secondary legislation:

summary of responses

December 2013

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1 Introduction

1.1 In July 2013 HM Treasury published the consultation document *Banking Reform: draft secondary legislation*.[1] The document invited comments on four draft statutory instruments to be made under the Financial Services (Banking Reform) Bill.

1.2 The four statutory instruments covered were the:

- Ring-fenced Bodies and Core Activities Order;
- Excluded Activities and Prohibitions Order;
- Banking Reform (Loss Absorbency Requirements) Order; and
- Fees and Prescribed International Organisations Regulations.

1.3 The consultation ran until 9 October 2013, during which time the government received 51 written responses from interested organisations. A list of the organisations that responded is provided in Annex A.

1.4 This document summarises the responses received and sets out the government's proposed next steps. The government is grateful to all those who contributed their views during the consultation process.

[1] https://www.gov.uk/government/consultations/banking-reform-draft-secondary-legislation

2 Summary of responses

Ring-fenced Bodies and Core Activities Order

2.1 This Order sets out the scope of ring-fencing, by specifying which entities are excluded from the definition of a 'ring-fenced body' and therefore do not have to ring-fence, and which deposits are not 'core deposits' which may only be held in a ring-fenced body.

Definition of 'core deposits'

High Net Worth Individuals (HNWIs), family members of HNWIs, Large Organisations and Financial Institutions

2.2 There was broad agreement among respondents who commented on this issue that sophisticated depositors, such as large organisations, financial institutions and high net worth individuals, should be able to opt to bank with a non-ring-fenced bank. [1] Most of those respondents agreed that the thresholds in the draft Order were set at the appropriate level, though some argued that the £250,000 HNWI threshold for eligibility to opt out was too low.

2.3 Respondents agreed that those wishing to deposit with non-ring-fenced banks should be required to certify their eligibility and desire to do so. However, many of those respondents felt that the processes set out in the draft Order were too burdensome, or that the statement prescribed for HNWIs was not sufficiently clear. For example, some suggested that when a bank has clear evidence that an organisation or person qualifies then it should not be necessary for the depositor opting out to provide further evidence. Some also thought that the draft Order required re-certification too frequently, and suggested that the re-certification process could be made simpler than the initial certification process.

2.4 There were also a number of further technical comments on the proposed certification process. These included how linked or partner enterprises would be defined; which foreign exchange rates should be used; the status of deposits made by financial institutions in respect of client money; and the precise process for an accountant to certify a HNWI's total wealth.

Institutions exempted from ring-fencing

De minimis

2.5 There was broad agreement among the respondents who commented on this issue with the proposed *de minimis* exemption for small banks. Respondents felt that it was appropriate that ring-fencing applies only to systemically important banks, and that exempting small banks from ring-fencing would encourage entry and competition in the banking market. Most of those respondents agreed with a threshold of £25 billion of core deposits, though some argued for a lower figure.

2.6 Some respondents made technical comments on the exemption, emphasising the importance of customers being able to distinguish clearly between ring-fenced banks and

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

exempt banks, and the need to avoid 'cliff edge' effects around the *de minimis* threshold. Some respondents suggested a solution to this could be to allow banks below the threshold voluntarily to become ring-fenced banks.

Other comments

2.7 Most respondents who commented on this issue agreed that ring-fencing should only apply to banks, though some expressed concern that this exemption may incentivise migration of risky activities into non-bank sectors. One respondent suggested that exemptions should be based on size, not type, of institution. Some respondents also raised concerns about the practical implications of retail deposits in UK banks' EEA branches becoming 'core', in particular potential difficulties involved in moving such deposits to another legal entity.

Excluded Activities and Prohibitions Order

2.8 This Order sets out in detail the circumstances in which a ring-fenced body may deal in investments as principal (the excluded activity created in the Bill), provides for other activities which ring-fenced bodies may not undertake, and imposes a number of prohibitions on ring-fenced bodies. It also specifies exceptions to those exclusions and prohibitions.

Excluded activities

Additional excluded activities

2.9 Most respondents who commented on this issue agreed that commodities trading should be an excluded activity. Some respondents raised concerns that the proposed definitions of commodities may prevent ring-fenced banks from buying commodities for their own use. They suggested that the definition of dealing in commodities should be made more consistent with that of dealing in investments as principal.

2.10 Some respondents thought that the exemption allowing dealing in commodities when the commodities in question form part of the security taken for a loan is too narrow, and suggested the exemption be broadened to cover exposures other than loans, such as trade finance facilities. Others proposed that ring-fenced banks be permitted to trade in commodities or commodity derivatives in order to balance their exposure in respect of selling commodity derivatives.

Exemptions from excluded activities

Simple Derivatives

2.11 The respondents who commented on this exemption generally agreed that ring-fenced banks should be permitted to enter into simple derivatives contracts with their customers. Some agreed that the derivatives permitted in the draft Order would enable small businesses to hedge the most commonly encountered risks, while others expressed concern that the products covered by the draft Order may not be sufficient to meet customers' most common needs directly from ring-fenced banks. Some expressed a general concern that limiting the types of risks businesses can hedge with ring-fenced banks could hinder their ability to manage their risks effectively – notwithstanding the availability of such products from other (non-ring-fenced) sources. Others proposed additional specific risks businesses commonly need to hedge against such as inflation or weather risk.

2.12 Some respondents argued that there is demand from corporate customers for products such as FX options and that therefore ring-fenced banks should be allowed to sell such products in addition to forward, future and swap contracts. They agreed, however, that typical customers of ring-fenced banks would be unlikely to need more complex options, so preventing ring-

fenced banks from offering such products directly would be unlikely to impose significant practical difficulties for their customers.

2.13 Some respondents who commented on this issue disagreed with the use of the categories of derivative set out in the IFRS 13 accounting standard as a means for determining which derivative products should be permitted. Some expressed concern that such accounting standards are liable to change independently of legislation. There was also some concern that the definitions were not designed with the primary purpose of ensuring financial stability. Some respondents also asked for additional clarification about when during a product's lifetime the IFRS 13 criteria would be applied, as derivatives could change classification during their term.

2.14 Many respondents agreed with the policy intention behind the net cap, which limits the net market risk exposure that a ring-fenced bank can have as a result of its client derivatives portfolio. Some however thought that there were technical problems with the gross cap proposal, which caps the overall size of a ring-fenced bank's derivatives portfolio, counting individual contracts on a gross basis.

Securitisation of own assets and debt-equity swaps

2.15 Respondents supported an exemption for securitisation of own assets and conduit financing, but some argued that the exemption as currently drafted was too restrictive, raising a number of technical issues.

2.16 Respondents agreed that there should be an exemption permitting ring-fenced banks to acquire and subsequently dispose of shares in companies through debt-equity swaps, but some felt that the exemption in the draft Order was too narrow and did not sufficiently reflect current practices for debt-equity swaps.

Ancillary activities and structured products

2.17 Respondents agreed that ring-fenced banks should be permitted to engage in otherwise prohibited activities to manage their liquidity or hedge against risks which arise in the course of conducting permitted activities. However many argued that the Order did not cover all risks a ring-fenced bank may need to hedge against. Some argued against listing the specific risks that ring-fenced banks could manage, preferring a more general approach instead. Others suggested that hedging further risks should also be permitted, such as inflation risk and equity risk.

2.18 Most respondents who commented on this issue favoured allowing ring-fenced banks to offer at least some structured products. Several made the case that there is strong retail and SME customer demand for some categories of structured products, such as savings products, structured deposits and investments. Others also argued that allowing ring-fenced banks to offer a limited range of structured products would not pose challenges to resolution, with some suggesting that an approach similar that taken to simple derivatives should be taken. Several respondents argued that, without an exemption, neither ring-fenced banks nor non-ring-fenced banks would be able to offer retail structured deposits, and expressed concern about the effect this would have on the UK structured deposits market.

Prohibitions on exposures to financial institutions

2.19 The respondents who commented on prohibitions agreed that in general, ring-fenced banks should be prohibited from having exposures to financial institutions, but some felt that more exemptions were needed. Many argued that the definition of financial institutions is currently too wide and would prohibit ring-fenced banks from carrying out a range of activities it requires to undertake in the normal course of business, as well as prohibiting many business

as usual relationships and services. Some suggested that the regulator be given discretion over which exposures to financial institutions should be permitted.

2.20 Respondents welcomed provisions allowing ring-fenced banks to securitise their own assets. However, many raised technical concerns with the exemption in the draft Order, which they argued would not meet the stated policy objective and would not permit many forms of securitisation and covered bond programmes as they are currently structured.

2.21 While some respondents opposed either a small bank or a small funds exemption from the prohibition on financial institution exposures, most respondents supported the creation of a small bank exemption, arguing that small banks' access to funding from ring-fenced banks should not be restricted. Some respondents suggested permitting small banks to opt in to ring-fencing.

Payment services exemption

2.22 Respondents generally supported the proposed exemption for exposures to financial institutions that arise in the course of providing payments services, though some argued that real time monitoring of such exposures would be very difficult or costly to implement in practice. Some respondents also argued that it would be difficult to monitor aggregate exposures against the limit; one also argued that that the individual customer limits proposed were too low. Some respondents suggested that the regulator should be responsible for setting the exposure limits.

2.23 Respondents agreed that ring-fenced banks should be direct participants in the payments systems that they use. Many argued that subsidiaries of ring-fenced banks should be permitted to access payments services through its parent ring-fenced bank or a ring-fenced bank in the same group. Some respondents highlighted potential complications arising from banks requiring separate payment systems memberships for their ring-fenced and non-ring-fenced banks.

Trade finance exemption

2.24 Respondents welcomed the exemption allowing ring-fenced banks to offer trade finance services. Some respondents thought that the trade finance exemptions were too narrow and would limit the services that ring-fenced banks could offer UK businesses seeking to trade internationally. They suggested that any trade finance products should be permitted, provided they were clearly linked to an underlying 'real economy' trade transaction.

2.25 Most respondents felt that the limits were appropriate now, but some noted the importance of ensuring they are updated appropriately to reflect future market developments. Some suggested that the regulator should be responsible for setting, and updating, the limits.

Liquidity management exemption

2.26 Respondents generally agreed that ring-fenced banks should be permitted to buy, sell or hold securities eligible for their regulatory liquid asset buffers to manage their liquidity. Some respondents, however, argued that the range of liquid assets permitted under the draft Order was too narrow, and suggested that the definitions of permitted assets be aligned with international standards.

Geographical restrictions

2.27 Respondents who commented on geographical restrictions generally agreed with the government's proposal to prohibit ring-fenced banks from having branches or subsidiaries carrying out activities that would be regulated within the UK outside the EEA. However some thought that this would result in increased cost and complexity for UK companies who do business outside the EEA. One respondent did not agree with the prohibition at all.

2.28 Respondents welcomed the exemption the government proposed to allow ring-fenced banks to have branches in the Crown Dependencies. However, some thought that this exemption should be extended to locally incorporated subsidiaries in the Crown Dependencies. Some respondents thought that the Financial Services Compensation Scheme should be extended to cover branches of ring-fenced banks in the Crown Dependencies.

2.29 Respondents highlighted technical areas where they thought the interaction of this proposed exemption with the Ring-fenced Bodies and Core Activities Order and the exemptions on acquiring shares in this Order needed further clarification. One example given was how HNWI and large organisation exemptions will apply to Crown Dependency branches and whether deposits in the Crown Dependency branches would be classified as core deposits.

2.30 One respondent thought that the regulator should, on a case by case basis, have the power to permit ring-fenced banks to have branches elsewhere outside the EEA, for example to access US funding sources through a US branch.

Banking Reform (Loss Absorbency Requirements) Order

2.31 This Order sets out the framework within which non-capital primary loss-absorbing capacity (PLAC) requirements will be imposed by the regulator on systemic UK banks and building societies.

PLAC composition

2.32 Most respondents did not comment on the Banking Reform (Loss Absorbency Requirements) Order. Of those that did, respondents in general thought that the government's proposed eligibility criteria for debt instruments were appropriate. Some respondents argued that additional criteria, such as a requirement to issue eligible instruments from a holding company, would make the requirements too complex and inflexible.

2.33 Most thought that the eligibility criteria for debt instruments to count towards an institution's PLAC requirement should align with eligibility criteria for the 'minimum eligible liabilities requirement' in the European Commission's forthcoming Recovery and Resolution Directive (RRD). Indeed respondents argued that the Order should align with and refer to European legislation in general.

2.34 One respondent suggested that the eligibility criteria should be as wide as possible, with all liabilities with remaining maturity of 12 months being eligible. Another respondent thought that the minimum remaining term required for a debt instrument to count towards PLAC should be reduced to bring it more in line with liabilities that are eligible for bail-in.

2.35 Respondents sought clarification on the technical details of the Order such as the eligibility of certain kinds regulatory capital and long-term debt to count towards an institution's PLAC requirement and how an institution's debt requirements and own funds are measured.

PLAC requirements

2.36 Respondents in general thought that the government's proposed calibration mechanism for non-capital PLAC requirements was appropriate, although some proposed alternatives. Many respondents stressed that requirements should align with European legislation. One respondent argued that deposit-takers below the ring-fence *de minimis* should not be subject to PLAC requirements.

2.37 Some respondents suggested that further clarity was required on how the regulator may use its discretion to set additional non-capital PLAC requirements on an institution, having taken into account its resolution strategy. Respondents were concerned that this discretion be used

proportionately and transparently, with one respondent seeking further clarity on the level the total PLAC requirement could be raised to.

2.38 Some respondents argued that risk-weighted assets were the appropriate metric to set PLAC requirements against rather than the liabilities metric currently contained in the forthcoming RRD. Some respondents called for the PLAC requirements to respect different business models.

2.39 Finally, some respondents supported the requirement for the regulator to consult HM Treasury on the non-capital PLAC requirements it will apply to institutions under the Order.

Fees and Prescribed International Organisations Regulations

2.40 These Regulations 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.

2.41 Most respondents either did not address the draft Regulations on fees and prescribed international organisations, or stated that they had no views on its content. Of those that did, one expressed concern at the breadth of powers the draft Regulations would give to HM Treasury to impose fees on the financial services industry. This respondent argued that the power should be subject to independent oversight and that the regulator is not sufficiently independent of government to fulfil this role effectively.

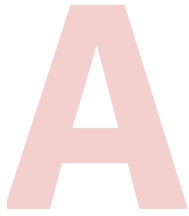
2.42 One respondent argued that the financial services industry should be consulted on any change in the scope of organisations covered by the Regulations or on any exercise of the power to make capital contributions to fund such organisations. Finally, one respondent argued that fees for the UK's participation in the Financial Stability Board should only be levied on systemic banks.

3 Next steps

3.1 The government is grateful to all those who contributed their views during the consultation process.

3.2 The government remains committed to having all legislation necessary to implement the recommendations of the Independent Commission on Banking in place by the end of this Parliament. The government will introduce final versions of the secondary legislation to Parliament at an appropriate point following the granting of Royal Assent to the Bill.

3.3 During this time the government will engage further with stakeholders and take into account responses to the consultation document when producing revised and final versions of the secondary legislation.



List of respondents

Allen & Overy LLP

Aon Hewitt Limited

Asset Based Finance Association

BACs Payments Schemes Limited

Barclays Bank plc

British Bankers' Association (BBA)

Building Societies Association (BSA)

CGI IT UK Limited

CHAPS Clearing Company Limited

Cheque & Credit Clearing Company Limited

Close Brothers Group plc

CLS Bank International

Confederation of British Industry (CBI)

Deloitte LLP

Drax Group plc

Finance and Leasing Association

Financial Markets Law Committee

Hampshire Trust Plc

HSBC Holdings plc

Institute of Chartered Accountants in England and Wales (ICAEW)

Institute and Faculty of Actuaries

Investec Bank plc

Investment Management Association

International Swaps and Derivatives Association, Inc. (ISDA)

Isle of Man Government

Joint Associations Committee on Retail Structured Products

Legal & General Group

Lloyds Banking Group

Loan Market Association

National Grid plc

Nationwide Building Society

Norton Rose Fulbright LLP

Payments Council

R Raphael & Sons plc

Renishaw plc

Rexam plc

Royal Bank of Scotland Group plc

Santander UK plc

Schroder & Co. Ltd

Standard Chartered Bank

States of Guernsey

States of Jersey

Symphony Group plc

The Association of Corporate Treasurers

The Co-operative Banking Group

The Law Society

Unite

Virgin Money Holdings (UK) Ltd

Wealth Management Association

Yorkshire Building Society

Yorkshire Water Services Limited

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