Title: Financial sector resolution: broadening the regime	**Impact Assessment (IA)**
IA No: HMT1202	**Date:**
Lead department or agency: HM Treasury	**Stage:** Final Proposal
Other departments or agencies: N/A	**Source of intervention:** Domestic
	Type of measure: Primary legislation
	Contact for enquiries: non-bank.resolution@hmtreasury.gsi.gov.uk

Summary: Intervention and Options

RPC Opinion: Awaiting Scrutiny

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**
N/A	N/A	N/A	No	N/A

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

Similar to banks, non-bank financial institutions are a very significant part of the financial system and can also be systemic. The UK currently has no way to resolve systemic non-bank financial institutions in an orderly manner, meaning that their disorderly failure could generate very significant costs for the economy. Further, because these costs are so great, the perception is created that the Government would step into prevent any such failure – effectively guaranteeing these institutions. This perception of an implicit government guarantee is a subsidy that incentivises excessive risk-taking and distorts financial markets, leading to the inefficient allocation of resources. And if the Government does have to bail-out a failing institution, taxpayer funds are put at risk.

What are the policy objectives and the intended effects?

The policy objectives are to ensure that if a systemic non-bank financial institution fails it can do so without threatening financial stability or imposing significant costs on the wider economy, and without requiring a Government bail-out. The intended effects are to reduce the likelihood and severity of financial crises by ensuring that the authorities have the necessary tools to deal with a failing non-bank financial institution. And also to remove or reduce the perception of an implicit government guarantee.

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

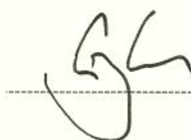
The two broad options being considered by the Government to address the risks to stability posed by the failure of non-bank financial institutions are to:

- Policy Option 1 – 'Do nothing': the UK Government doing nothing and relying on existing insolvency arrangements to deal with the failure of non-bank financial institutions; and
- Policy Option 2 – 'UK action': the UK Government taking action to introduce, via domestic legislation, resolution regimes for certain non-bank financial institutions – investment firms, parent undertakings and central counterparties – together with supporting stabilisation powers. The Government's view is that the benefits of Policy Option 2 far outweigh the costs. This is the Government's preferred option.

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

Does implementation go beyond minimum EU requirements?			N/A		
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, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister:  Date: 24/9/12

Summary: Analysis & Evidence

Policy Option 1

Description: The UK Government doing nothing and relying on existing insolvency arrangements to deal with the failure of non-bank institutions.

FULL ECONOMIC ASSESSMENT

Price Base Year N/A	PV Base Year N/A	Time Period Years N/A	Net Benefit (Present Value (PV)) (£m)		
			Low: N/A	High: N/A	Best Estimate: N/A

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

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

Zero

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

Zero

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

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

Zero

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

Zero

Key assumptions/sensitivities/risks

Discount rate (%) N/A

N/A

BUSINESS ASSESSMENT (Policy 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: The UK Government taking action to introduce, via domestic legislation, resolution regimes and supporting stabilisation options for investment firms, parent undertakings and central counterparties.

FULL ECONOMIC ASSESSMENT

Price Base Year N/A	PV Base Year N/A	Time Period Years N/A	Net Benefit (Present Value (PV)) (£m)		
			Low: N/A	High: N/A	Best Estimate: N/A

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

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

The proposals under Policy Option 2 do not require the firms that are affected to take any action. So on one level, the costs of the proposals are therefore **zero**. However, the effect of the proposals is that counterparties may be inclined to deal with systemic financial institutions on less favourable terms. This cost will be difficult to monetise or will be non-monetisable. Accordingly, a qualitative assessment is made of the likely impact of the proposals.

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

The proposals will mean that risk and reward in transactions to which the affected firms are party are better aligned. This will reduce incentives for excessive risk-taking, but in the short-term, may impose some costs on the affected firms. Firms may pass some of these costs on to customers, constraining the price and/or availability of some financial services. So some short-term costs for customers may result – but these should be set against the potentially very significant benefits of reduced risk and severity of financial crises.

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

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

The benefits arising as a result of the proposed reforms will be difficult to monetise or will be non-monetisable. Accordingly, a qualitative assessment is made of their likely impact.

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

Having a robust resolution regime for investment firms, parent undertakings and CCPs will allow the authorities to manage the orderly failure of systemic firms. This reduces the probability and severity of financial crises, without requiring public funds to bail out failing firms. The benefits are potentially very significant, as financial crises have been estimated to cost up to £40bn per year.

Key assumptions/sensitivities/risks — **Discount rate (%)** N/A

N/A

BUSINESS ASSESSMENT (Policy 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. In August 2012 the Government published a consultation document[1] discussing proposals for enhancing the mechanisms available for dealing with the failure of systemic non-banks. The consultation document covered four broad groups of non-banks, as follows:
   - (i) investment firms and parent undertakings;
   - (ii) central counterparties (CCPs);
   - (iii) non-CCP financial market infrastructures (non-CCP FMIs); and
   - (iv) insurers.
2. The Government has received a range of responses to the consultation, including from industry bodies (such as the British Bankers' Association and the Investment Managers' Association), banks, investment firms and CCPs.
3. The Government is now proposing to bring forward legislation in the Financial Services Bill to introduce powers to facilitate the resolution of systemic investment firms, parent undertakings and CCPs. This 'final proposal' stage impact assessment analyses the costs, benefits and likely impact of two policy options and sets out the case for Government intervention through the proposals that are included in the Financial Services Bill.
4. The assessment follows on from the 'consultation stage' impact assessment published alongside the consultation document in August. The analysis has been updated to reflect changes of policy, and to incorporate additional evidence where available.

Scope

5. Given that the proposals to be included in the Financial Services Bill only relate to the resolution of systemic investment firms, parent undertakings and central counterparties (CCPs), only their impact is considered in this impact assessment. Non-CCP FMIs and insurers are not addressed.
6. For insurers, although the consultation document acknowledged the likelihood of such institutions having some degree of systemic potential, the Government does not have a firm view on the appropriateness of introducing a comprehensive resolution regime to respond to the risk they may pose to financial stability. Similarly, the Government does not have a firm view on the best approach for dealing with threats to the viability of non-CCP FMIs. The Government is continuing to develop its thinking on these two groups.

Terminology

7. The costs and benefits identified for the policy proposals under consideration are classified as being either **direct** or **indirect**. Direct costs and benefits are first round effects that are directly attributable to the proposals coming into force, and will impact on the investment firms, parent undertakings and CCPs that are directly affected. Indirect costs and benefits, on the other hand, are second round effects that can be expected to follow on dynamically from the implementation of the proposals.
8. Irrespective of whether costs and benefits are direct or indirect, their impact will also either be **monetisable** or **non-monetisable**. Monetisable costs and benefits are those that, given the current evidence, the Government is able to estimate quantitatively. As highlighted in later sections, the costs and benefits, whether direct or indirect, arising as a result of the proposed reforms will be difficult to

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[1] HM Treasury, 2012, *Financial sector resolution: broadening the regime:* http://www.hm-treasury.gov.uk/d/condoc_financial_sector_resolution_broadening_regime.pdf.

monetise or will be non-monetisable. In these instances, a qualitative assessment is made of their likely impact.

9. Monetisation is extremely difficult. These proposals are only one element of the wider, ongoing reform of the financial sector. So where costs and benefits arise, it is difficult to ascertain which reforms have given rise to which costs and benefits. Further, the principal benefits of these reforms will be a reduction in the likelihood and severity of future financial crises, and the costs of financial crises – while often very large – are impossible to predict accurately.

Structure of this impact assessment

10. The rest of this impact assessment is structured as follows:
    1. Rationale for action by the Government
    2. Policy objectives
    3. Description of policy options
    4. Impact of policy options and analysis of costs and benefits
    5. Wider impacts

RATIONALE FOR ACTION BY THE GOVERNMENT

11. The 2007-09 financial crisis exposed a great many flaws in the global financial system. In particular, systemic banks, when they ran into trouble, could not be allowed to collapse in a disorderly way, because of the damage this would have done to the financial system and the wider economy. With no alternatives, the taxpayer was forced to step in and bail-out failing banks.

12. To address the problems, a wide-ranging programme of banking and wider financial sector reform is underway at European and global level. The UK is actively engaged in this and is also taking action domestically. When it came into office, the Government asked the Independent Commission on Banking to recommend ways to strengthen the resilience of the banking system and promote competition.

13. In June this year the Government published a white paper setting out how it would implement those recommendations.[2] The UK also already has in place a special resolution regime (SRR) for banks, as well as enhanced capital and liquidity regimes. Collectively, these reforms seek to ensure that banks are better able to cope with shocks in the future and that, if banks do fail, they can be resolved safely without risk to the taxpayer or to financial stability.

14. But banks are only part of the financial system. Other types of financial institutions can also pose a risk to financial stability, if there is no way for them to fail safely. The disorderly failure of financial market infrastructures (FMIs) – systems that connect market participants to each other – could also severely disrupt both financial markets and the normal functioning of the wider economy.

15. The potential economic cost of allowing systemic non-bank financial institutions or FMIs to collapse means that they too may need taxpayer support should they run into trouble, if there is no way for them to fail safely. For example, in the recent crisis, the US authorities provided taxpayer-funded support to bail out Bear Stearns (an investment firm), AIG (an insurer) and also to underpin money market funds.

16. The expectation is that resolution powers for the non-bank financial institutions under consideration (systemic investment firms, parent undertakings and central counterparties) would be introduced at the European level eventually. However, this process is expected to take a number of years to conclude.

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[2] HM Treasury and the Department for Business, Innovation & Skills, 2012, *Banking reform: delivering stability and supporting a sustainable economy*: http://www.hm-treasury.gov.uk/d/whitepaper_banking_reform_140512.pdf.

17. Because of these risks, in its banking reform white paper, the Government undertook to explore the case for addressing gaps in the resolution regime framework for non-banks on a more accelerated timetable than that currently envisaged in ongoing international work.

18. In a consultation document published in August this year,[3] the Government proposed enhancing the mechanisms available for dealing with the failure of systemic non-banks.

19. A key consideration in taking forward these proposals is whether the best response might be extending and/or strengthening existing administration/run-off arrangements as opposed to introducing a new, comprehensive resolution regime. A balance needs to be struck between enhancing financial stability, and ensuring that the regulatory regime is not unnecessarily complex or burdensome (for the authorities, and industry).

POLICY OBJECTIVES

20. The Government's overall rationale for acting is to protect financial stability by ensuring a robust regime, supported by stabilisation tools, is in place for managing the failure, or likely failure, of any non-bank financial institution with the potential to be systemic. The options and proposals set out in the consultation document are targeted at achieving this in line with the following objectives:
    - strengthening the stability and resilience of the financial system by preventing contagion and maintaining market discipline;
    - reducing the likelihood of individual firms threatening the wider stability of the UK if they get into difficulties;
    - ensuring the continuity of critical market functions; and
    - protecting depositors, client funds and client assets.

21. The Government will be seeking to achieve the above objectives whilst also ensuring that;
    - taxpayer interests are protected; and
    - the interference with rights in contravention of a right within the meaning of the Human Rights Act 1998 is avoided in so far as is reasonably possible.

22. These objectives are consistent with international initiatives to promote financial stability, in particular:
    - work on resolution regimes by the Financial Stability Board (FSB);
    - publication of a draft Recovery and Resolution Directive (RRD) by the European Commission in June this year; and
    - the publication of a consultation paper by joint the Committee on Payment and Settlement Systems (CPSS) and International Organization of Securities Commissions (IOSCO) working group (henceforth CPSS-IOSCO) in July this year.

    These are briefly discussed immediately below.

Financial Stability Board's Key Attributes

23. The FSB published the Key Attributes of Effective Resolution Regimes for Financial Institutions in November 2011 which sets out the responsibilities and powers that national resolution regimes should have to resolve a failing systemically important financial institution (SIFI). More specifically, the Key Attributes recommend jurisdictions to:
    - ensure resolution authorities have a broad range of powers to intervene and resolve a financial institution that is no longer viable;
    - remove impediments to cross-border cooperation;
    - ensure that recovery and resolution plans are put in place for all global SIFIs; and

[3] HM Treasury, 2012, *Financial sector resolution: broadening the regime:* http://www.hm-treasury.gov.uk/d/condoc_financial_sector_resolution_broadening_regime.pdf.

- maintain Crisis Management groups for all global SIFIs.

24. The UK has a long term commitment, along with other G20 countries, to implement the Key Attributes for Effective Resolution Regimes published by the FSB. This includes introducing resolution regimes for any type of financial firm with the potential for causing a systemic impact in the event of failure – including holding companies, investment firms, insurance companies and FMIs.

25. Further to the Key Attributes, the UK Government expects the European process to introduce resolution regimes for each of the non-bank financial institutions under consideration in due course but according to different timetables.

European Commission's Recovery and Resolution Directive

26. The European Commission's proposed RRD would require Member States to introduce resolution regimes for deposit takers and investment firms and their parent undertakings. The proposal covers 3 broad areas: preparation and prevention, early intervention, and resolution[4]. It also covers provisions on cross-border cooperation and resolution financing. The proposed stabilisation tools to be included in the RRD include:

    - a sale of business tool whereby the resolution authority would sell all or part of the failing firm to a private sector purchaser;
    - the bridge tool which consists of identifying the good assets or essential functions of the failing firm and separating them into a new bridge entity which would eventually be sold to another entity. The failed firm with the bad or non-essential functions would then be placed into insolvency proceedings;
    - an asset separation tool, whereby the bad assets of the failing firm are put into an asset management vehicle. The tool may be used only in conjunction with another tool (bridge entity, sale of business or write-down). This ensures that while the failing firm receives support, it also undergoes a restructuring; and
    - a debt write-down tool ("bail-in") whereby the failing firm would be recapitalised with shareholdings wiped out or diluted, and relevant creditors having their claims reduced or converted to shares.

27. In terms of implementation, the Commission's published intention is that Member States will be required to transpose the framework by 1 January 2015. The bail-in tool, however, has a longer implementation timeframe and is expected to be implemented by 1 January 2018 at the latest.

CPSS-IOSCO consultation document

28. Following the publication of the FSB's Key Attributes, the FSB noted that not all resolution powers will be suitable for all sectors and all circumstances, and, in the context of Financial Market Infrastructure (FMI) (including CCPs), the choice of resolution powers should be guided by the need to maintain continuity of critical FMI functions.

29. As such, a joint Committee on Payment and Settlement Systems (CPSS) and International Organization of Securities Commissions (IOSCO) working group (henceforth CPSS-IOSCO) has – with the support of the FSB – been conducting work on the appropriateness of the FSB's Key Attributes for resolution regimes for financial market infrastructure. In particular, CPSS-IOSCO is considering the need for CCPs to introduce loss-sharing rules, and, whether specific resolution arrangements for FMIs are needed. It published a consultation paper in July this year.

30. The UK expects that, in due course, the European Commission will propose measures to require Member States to introduce resolution regimes for CCPs in line with, or closely following, recommendations to be set out by CPSS-IOSCO. The tools likely to be incorporated into any European legislation covering resolution powers for central counterparties include:

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[4] The consultation document only included proposals relation to the resolution elements of the RRD.

- transfer powers enabling the transfer of ownership and or some/all of the assets, rights and liabilities or securities of a failed FMI (subject to a number of conditions) to either a private sector purchaser or a bridge entity;
- loss allocation rules, or similar powers for imposing losses, to effect the allocation of losses among participants to prevent the failure of the FMI;
- a moratorium preventing outgoing payments from a FMI and a stay on creditor actions to attach assets or otherwise collect money or property from the entity which is under resolution; and
- a "bail-in" power to enable Government to write down or convert unsecured and uninsured claims with a view to maintaining critical operations and services of a FMI.

31. However, the timetable for any future EU legislative action is unclear, and the UK Government does not expect that powers to resolve a central counterparty will be made available through the European process for a number of years.

DESCRIPTION OF POLICY OPTIONS

32. The two broad options to address the risks to financial stability posed by the failure of systemic investment firms, parent undertakings and CCPs considered in this impact assessment are:
    - 'Do Nothing' option: the UK Government does not take any action at this stage to implement the proposals discussed in the consultation document; and
    - 'UK Action' option: the UK Government takes action, via domestic legislation, to enhance the mechanisms available for dealing with the failure of systemic investment firms, parent undertakings and CCPs.

Policy Option 1 – 'Do Nothing'

33. Under this option, the UK Government does not take any action at this stage to implement the proposals discussed in the consultation document to address the risks posed by the failure of systemic investment firms, parent undertakings or CCPs.
34. Note, however, that the Government introduced the Special Administration Regime (SAR) – a bespoke administration procedure for investment firms – in February 2011. The SAR requires an administrator of an investment firm to ensure the return of client money or assets as soon as is reasonably practicable; to ensure timely engagement with market infrastructure bodies and the Authorities; and to either rescue the investment firm as a going concern, or wind it up in the best interests of creditors. In October 2011 MF Global Limited became the first firm to enter the SAR.
35. The Banking Act 2009 requires the Government to review the regulations governing the SAR by February 2013, reporting to Parliament on how far the regulations achieve their objectives and whether they should continue to have effect. The Government will take this opportunity to look at broader issues arising from the MF Global administration, in particular obstacles to the timely return of client assets and money to investors. This review will be run in tandem with the FSA's review of its Client Assets rulebook. Further details will be announced shortly.
36. Note also that CCPs and their members have also begun to implement for some business lines contractual agreements to distribute losses amongst members in the event that a CCP is exposed to uncovered losses. And as discussed above, in July this year CPSS-IOSCO published for public comment a consultative report on the recovery and resolution of financial market infrastructures (including CCPs).

Policy Option 2 – 'UK Action'

37. Under this policy option, the UK Government takes action domestically, in advance of any European process, to introduce resolution regimes to ensure that the authorities have the tools to allow them to manage the orderly resolution of systemic investment firms, parent undertakings and CCPs.

38. Three key elements in the design of a resolution regime are:

    - scope – which firms are covered?
    - trigger for intervention – at what point can the authorities use the tools available to them under the resolution regime in order to address a failing financial institution?
    - powers – once the trigger for intervention has been met, what are the powers that the authorities will be able to use?

39. These elements of the proposed resolution regimes for (i) investment firms and parent undertakings; and (ii) CCPs are set out in turn below.

Investment firms and parent undertakings

Scope

40. Under the proposals, an enabling power will be taken to allow the precise scope of firms covered by the proposed resolution regime to be set out in secondary legislation. The August white paper proposed a broad scope, but in light of feedback from industry, and after further consideration, the Government's view is that a narrower scope would be preferable. A broad scope would capture all firms – but as the objectives of the proposal focus on systemic financial institutions, a scope that captures all firms, including the smallest, would be unnecessarily wide. Some firms may potentially be covered by both the resolution regime under the Banking Act 2009 and the proposals under this Policy Option 2. The scope as set out in secondary legislation will therefore need to provide clarity on which resolution provisions and which resolution objectives apply to which firms.

Trigger for intervention

41. In order for the authorities to use a stabilisation power in respect of an investment firm or parent undertaking of an investment firm or bank, a two-stage trigger must be satisfied, as follows:

    - the investment firm or bank must have failed, or be likely to fail, to meet its regulatory threshold conditions, and it is not likely that action will be taken to enable the firm to meets its threshold conditions; and
    - the failure of the investment firm or bank must be considered to be of systemic importance.

Powers

42. The powers being proposed by the Government are similar to the stabilisation tools available under the Banking Act 2009. The powers would provide the resolution authority with the ability to transfer ownership and or some/all of the assets, rights and liabilities or securities of a failed firm (subject to a number of conditions) to either:

    - a private sector purchaser;
    - to a bridge bank wholly owned and operated by the Bank of England; or
    - temporary public ownership.

43. In relation to parent undertakings, the proposed stabilisation powers would only be exercisable in relation to its financial holding companies. And where a parent undertaking owns both financial and non-financial subsidiaries and an intermediate holding company exists and owns the systemic financial subsidiary, stabilisation powers would only be exercisable at the intermediate level.

Private sector purchaser

44. This tool would empower the resolution authority to transfer the business of a failing firm either by the transfer of the shares, or of its property, rights and liabilities, to a private sector purchaser who is willing to accept the transfer.

45. The resolution authority would only use this power in situations where the conditions for entering the resolution regime are met and there are sufficient public interest grounds for intervention.

Bridge bank tool

46. This tool would enable the resolution authority to facilitate the transfer of some of an investment firm's or parent undertaking's assets, rights and liabilities to another company (a 'bridge entity') with the aim of ensuring that the new 'good' entity can continue to provide investment services whilst the original 'bad' firm continues to exist albeit that it is wound down over time. This approach may reduce contagion risk by ensuring the continuing function of the services of the firm.

47. If the resolution authority decides that a bridge is the most appropriate resolution tool, it will establish a separate company and apply transfer powers to transfer property, rights and liabilities from the failing firm to the bridge. Following the transfer, the resolution authority will stabilise the business and once a suitable private sector purchaser has been found, the entity will be sold.

Temporary public ownership

48. This tool would empower HM Treasury to transfer the business of a failing investment firm or parent undertaking either by the transfer of the shares, or of its property, rights and liabilities, into temporary public ownership. This power would be available to the Government as a last resort.

49. It is worth noting that HM Treasury already has the power to transfer the parent undertaking of a deposit-taking firm into temporary public ownership.

Central counterparties

Scope

50. The proposed resolution regime for CCPs would cover any Recognised Clearing House (under Part 18 of the Financial Services and Markets Act 2000) incorporated in the UK.

Stabilisation powers

Trigger for intervention

51. In order for the authorities to use a stabilisation power in respect of a clearing house, a two-stage trigger must be satisfied, as follows:

    - the clearing house must have breached, or be likely to breach, the conditions that it must meet in order to continue to be a recognised clearing house, and it is not reasonably likely that this will be remedied while maintaining the continuity of the provision of central counterparty clearing services (the 'general conditions');
    - the exercise of the power must be necessary, having regard to the public interest in the stability of the financial systems of the United Kingdom and the maintenance of public confidence in the stability of those systems (the 'specific conditions').

Transfer powers

52. These proposed powers include stabilisation powers enabling the transfer of securities, property rights and liabilities of the clearing house to another person, such as a private sector purchaser or a 'bridge' CCP owned and controlled by the Bank of England as resolution authority. They would be similar to the corresponding powers proposed for investment firms and parent undertakings, as described above.

Powers of direction

53. Under Policy Option 2, the authorities will also be granted powers of direction over CCPs, and over any administrator of a CCP.

Enhanced Power of Direction over a CCP

54. Building on the existing powers of direction which the Financial Services Authority has under the Financial Services and Markets Act 2000 (FSMA 2000), this power would enable the regulator to direct a CCP to take action (or to refrain from taking action) to protect and enhance financial stability, to maintain public confidence in the UK financial system, to maintain the continuity of services provided by the CCP and to maintain and enhance the CCP's financial resilience.
55. Specifically, the direction could also be employed to require a CCP to make changes to its rules, or introduce emergency rules or require rules to be activated. The Government considers such a power necessary to ensure that the authorities are able to protect against action, or inaction, by a CCP that might threaten the objectives set out in the previous paragraph.

Power of Direction over an Administrator

56. This power is intended to provide the resolution authority with the ability to direct the administrator of a failed CCP (subject to certain conditions) to take action to address risks to financial stability. It could be used in conjunction with the transfer powers (as outlined above) to require the CCP to continue to provide services in support of an acquirer of some of the CCP's business (such as a bridge entity).

IMPACTS OF POLICY OPTIONS AND ANALYSIS OF COSTS AND BENEFITS

Affected parties

57. Policy Option 1 – 'Do Nothing' – will have no impact.
58. The Government's preferred proposals presented in this impact assessment as Policy Option 2 are expected to affect **directly** the following groups:
    - investment firms;
    - parent undertakings of investment firms and banks; and
    - CCPs

    (all as defined in more detail above).
59. Note, however, the proposals are designed to target systemic firms, of which there are likely to be only a few in each of these three categories, and the authorities powers under the proposals (as described above) can only be exercised over such firms. The proposals will not have a material impact on other firms.
60. The Government's proposals presented as Policy Option 2 will also **indirectly** affect a far wider range of parties. Most immediately this will include customers, members and investors of directly affected firms. But the impact on these parties will have a knock-on effect on economic activity more broadly. The recent financial crisis has shown how connections within the financial sector, and between the financial sector and the wider economy, mean that events originating in the financial sector can impact on households, firms and governments.

Impact on micro-businesses of Policy Option 2

61. Given the interconnected nature of the financial services sector and its importance to the wider economy, the proposals have the potential to impact on micro-businesses[5] indirectly, to the extent that the proposals have social costs (for example, changes to the price and/or availability of services provided by investment firms, parent undertaking and CCPs) and social benefits (reduced likelihood and impact of financial crises).
62. However, there should not be any direct impact, as no micro-businesses are expected to be systemic non-bank financial institutions.

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[5] Micro-businesses have fewer than 10 employees.

63. The indirect impact is likely to be positive, as the benefits of increased financial stability can be expected to outweigh any social costs for the economy as a whole (discussed in more detail below.)

64. The Government is committed to ensuring that regulation is proportionate and will not have a disproportionate impact on small firms. The Government is satisfied that the impact of the proposals on small firms will be minimal.

Cost-benefit analysis

65. The **costs** of implementing proposals to improve the resolvability of systemic investment firms, parent undertakings and CCPs can be considered in two broad categories. First, any direct costs imposed on those institutions directly affected by the proposals, i.e. investment firms, parent undertakings and CCPs. Second, any indirect costs that arise from the way in which investment firms, parent undertakings and CCPs respond to the direct costs that they incur. In some circumstances, at least, this may result in changes to the price and availability of some services provided by these institutions. Price increases and constraints on availability of financial services will impose costs on customers, and will ultimately impact on GDP.

66. The **benefits** will principally derive from enhanced financial stability. By far the biggest potential benefit is the reduction in the expected costs from financial crises.

67. This section considers in more detail the costs and benefits of the Government's proposals to put in place a resolution regime for investment firms, parent undertaking and CCPs (Policy Option 2) against the counterfactual of no taking no action at this stage (Policy Option 1).

Costs of Policy Option 1

68. Policy Option 1 is 'Do Nothing', and so is the counterfactual against which the costs and benefits of the policy options considered in this impact assessment should be measured. Accordingly the costs of Policy Option 1 are zero.

Benefits of Policy Option 1

69. Policy Option 1 is 'Do Nothing', and so is the counterfactual against which the costs and benefits of the policy options considered in this impact assessment should be measured. Accordingly the costs of Policy Option 1 are zero.

Costs of Policy Option 2

Direct costs

70. The proposals under Policy Option 2 do not require any action to be undertaken by investment firms, parent undertakings or CCPs. On one level, the direct costs to such institutions of these proposals are therefore zero.

71. However, to the extent that market participants believe that the Government would not be willing to see an investment firm, parent undertaking or CCP fail, that firm enjoys a perceived implicit guarantee. This will means that those institutions' counterparties will be prepared to deal with them on more favourable terms.

72. The proposals under Policy Option 2 have as their goal ensuring that the authorities have the tools to manage the orderly failure of a systemic investment firm, parent undertaking or CCP with minimal risk to taxpayer funds. This necessitates removing or reducing the perceived implicit government guarantee – moving risk away from the taxpayer back on to financial institutions and their investors, where it belongs.

73. Some progress has been made in curtailing the perceived implicit guarantee. It can be argued that regulatory reforms that have already been undertaken – such as the implementation of the special resolution regime for banks – and the clear direction of travel of reform of the financial sector have already sent a strong signal to the market that systemic financial institutions cannot expect to receive taxpayer-funded bail-outs to the extent seen previously. The effect of this is that counterparties will

be inclined to deal with systemic financial institutions on **less** favourable terms, that more accurately reflect risk – and this represents a cost to those institutions.

74. But there is no consensus on the extent to which counterparties have already adjusted the terms on which deal with such institutions. And even if there were such a consensus, it would be very difficult to estimate the additional impact of the proposals under Policy Option 2. This means that it is not possible to quantify accurately the direct costs to investment firms, parent undertakings or CCPs of Policy Option 2.

75. Note that there are similar difficulties in quantifying the costs to systemic **banks** of ongoing measures to improve their resolvability and so remove or reduce the perceived implicit government guarantee that they enjoy. By way of example, the Government has made an estimate of the potential change in the terms on which one set of market counterparties – investors in long-term unsecured bank debt – are prepared to deal with banks as a result of the implementation of the recommendations of the Independent Commission on Banking. The Government has estimated that the price of this debt may increase by from 0 basis points to 200 basis points, largely as a result of the reduction in the perceived implicit government guarantee likely to follow from these recommendations.

76. This may not be a good proxy for likely direct impact on investment firms, parent undertakings and CCPs of Policy Option 2, as banks undertake different activities from these institutions – in particular, deposit-taking – and the ICB's recommendations are much more far-reaching than the proposals discussed in this impact assessment. But it does illustrate two relevant points. First, the difficulty in accurately quantifying the direct costs of proposals to reduce the perceived implicit guarantee. And second, the difficulty in determining the extent to which individual policies work to reduce the perception of an implicit government guarantee.

77. For example, assume that in response to the implementation of the ICB's recommendations a banking group splits itself into a ring-fenced bank and an investment firm, and that Policy Option 2 under consideration here is put in place. The cost of funding of the investment firm can be expected to rise. But it would be very difficult (if not impossible) to work out how much of that increase was caused by separating the activities of the ring-fenced bank and the investment firm, and how much was caused by implementing a resolution regime for investment firms.

Indirect costs

78. The indirect costs will be incurred most immediately by customers, members and investors of covered firms. But knock-on effects throughout the wider economy mean that there is the potential for other parties to be affected, if the effect of the proposals is to make financial markets less efficient, and more expensive for clients.

79. Where investment firms, parent undertakings and CCPs experience direct costs as a result of these proposals, they can respond in a number of ways. These can be split into two broad categories – responses that involve passing costs on to customers through changing the price and availability of services, and responses that involve absorbing costs themselves, for example, through lower returns for shareholders and/or lower pay for employees.

80. The impact on the former, in particular, may have a knock-on effect on economic activity more broadly. The recent financial crisis has shown how connections within the financial sector, and between the financial sector and the wider economy, mean that events originating in the financial sector can impact on households, firms and the government.

81. Again, it is very hard to estimate what these indirect costs might be. However, there are a number of reasons to think that they are likely to be small. One way in which CCPs' members / customers may suffer higher indirect costs is through CCPs requiring them to provide more collateral – or 'margin' – against CCPs' exposure. But CCPs have said that the real costs here will arise under the Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories (commonly known as the European Market Infrastructure Regulation or EMIR) and that the incremental effect of the proposals under consideration here is likely to be marginal. Further, the Government's assessment of the direct and indirect costs of implementing the ICB's recommendations was that the indirect costs were likely to be very much smaller than the direct costs – and while this might not be an entirely accurate proxy, it is nevertheless indicative.

82. And as discussed above, ensuring that the authorities are able to resolve systemic financial institutions removes or reduces the perceived implicit government guarantee. This is a subsidy, so – all other things being equal – its removal should make financial markets **more** efficient, not less. The fact that the proposals may impose some constraints on the price and availability of financial services is in no way inconsistent with this. For example, the ready availability of cheap credit in the run-up to the financial crisis represented – in some circumstances at least – a mis-pricing of risk and market inefficiency, which contributed very significantly to the crisis.

83. There may also be some indirect costs for the authorities in relation to operationalising the proposals under Policy Option 2. However, these proposals are designed to make it easier for the authorities to deal with the failure of certain systemic non-bank financial institutions, and (more broadly) to maintain financial stability. So it is not clear that the indirect costs for the authorities would be greater than in the counterfactual ('Do Nothing'), in which the authorities would not have access to the stabilisation powers proposed under Policy Option 2.

Benefits of Policy Option 2

84. The aim of the Government's proposals to enhance the mechanisms available for managing the failure of systemic investment firms, parent undertakings and CCPs is to promote greater financial stability in the UK and beyond (including in Europe). In the absence of a resolution regime for such institutions, there would be very significant costs to the wider economy of such firms going into insolvency.

85. Given their size and importance, failure would result in the removal or reduction of the provision of key services provided by that firm to its customers/clients/members. This would impair the functioning of financial markets by constraining the availability and/or increasing the price of critical financial services, with a knock-on adverse impact on the wider economy.

86. Moreover, the interconnected nature of modern financial markets and the financial exposures amongst market participants means that the effects of the collapse of a systemic firm can spread quickly and widely across markets, leading to contagion and resulting in a general loss of confidence within financial markets as a whole.

87. In the absence of any way of ensuring that systemic financial institutions can fail safely, governments use public funds to bail-out such firms when they do fail, at enormous cost to the taxpayer.

88. A robust resolution regime would provide the authorities with the tools to deal with a failing systemic investment firm, parent undertaking or CCP in an orderly way, without recourse to taxpayer funds. This would include ensuring that the continuous provision of critical financial services was maintained. And the potential for contagion to other financial institutions and markets, and loss of confidence in the financial system as a whole, would be contained.

89. Further, the existence of a credible resolution regime for dealing with investment firms, parent undertakings and CCPs without requiring support from the taxpayer means that risk and reward are better aligned. If market participants know that if a systemic financial institution fails the costs associated with the failure will be borne by that firm, its investors and its counterparties – not by the taxpayer – they will be incentivised to monitor the firm's risk-taking. This removes or reduces the incentives for excessive risk-taking that a government guarantee creates. So not only does a resolution regime mean that the failure of systemic firms can be managed in a way that limits the damage to financial markets and the wider economy, but by better aligning risk and reward and reducing incentives for excessive risk-taking, it means that firms are less likely to fail in the first place.

90. The proposed measures should therefore reduce the likelihood and impact of financial crises. This would result in a higher level of GDP in the long run (and as a consequence, all else equal, higher tax receipts). Curtailing the perceived implicit guarantee should also bring a benefit to the Government's borrowing costs, as sovereign debt investors see a reduction in the Government's contingent liability to the banking sector.

91. Accurately quantifying the benefits of Policy Option 2 is therefore extremely challenging – it would require an accurate assessment of the likelihood and severity of financial crises under the counterfactual of Policy Option 1 ('Do Nothing') and then a determination of how much these would be reduced by implementing Policy Option 2. 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.

92. In its report published in September 2011, the ICB concluded that the by far the biggest cost of financial crises was the adverse impact they have on the economy. On the basis of a review of the available academic literature, the ICB[6] calculated values for the probability of a crisis occurring in a given year (4.5 per cent) and the present value cost to GDP of a crisis occurring (63 per cent of GDP). These gave an annual cost of around 3 per cent of GDP, or around £40bn per year in 2010 terms. Note that this does not separately identify the costs of government interventions where taxpayer funds are used to support failing institutions. But such costs are implicitly included in the costs of reduced GDP. By way of example, Figure 1 shows UK GDP before and after the financial crisis of 2007-09, and also shows the path UK GDP would have taken had the level of growth in the run-up to the crisis been sustained. Figure 2 illustrates the increase in unemployment over the same period. Figure 1 shows that the costs in terms of GDP are already very significant, and they will continue to grow for as long as GDP is below the level it would have been at but for the crisis.

Figure 1: UK GDP

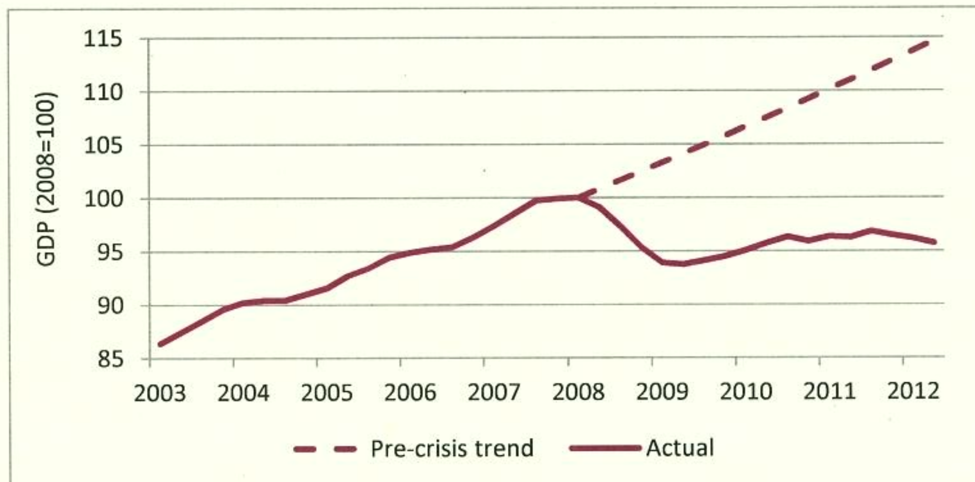

Figure 2: UK employment

93. Since the financial crisis of 2007-09, various regulatory reforms to improve financial stability have been implemented, and others are in train. It would be very difficult to assess accurately what impact each reform – including those under consideration here – would have in isolation on the probability and severity of future financial crises. But because the costs of financial crises are so high, the proposed measures under Policy Option 2 only need to reduce the probability and/or severity of a financial crisis by a small incremental amount in order to deliver a very significant benefit, in terms of a reduction in the annualised costs of financial crises.

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[6] Independent Commission on Banking, 2011, *Final Report:* http://bankingcommission.s3.amazonaws.com/wp-content/uploads/2010/07/ICB-Final-Report.pdf .

Conclusion on costs and benefits of policy options

94. As discussed above, it is very difficult to assess accurately the costs and benefits of Policy Option 2. However, it is clear that:

    - any **direct** costs will mostly arise from the removal or reduction of the perceived implicit government guarantee for systemic financial institutions. Any such guarantee represents a subsidy, and so – other things being equal – it will have a distortive effect on financial markets, incentivising excessive risk-taking and leading to the inefficient allocation of capital;
    - any **indirect** costs are likely to be very small; and
    - while it is hard to quantify the **benefits** that will accrue, these could be very large (as the annualised cost of financial crises determined as set out above is £40bn).

95. Notwithstanding the difficulty in accurately assessing the costs and benefits, the Government believes that the cost-benefit analysis of Policy Option 2 is strongly positive relative to the counterfactual 'Do Nothing' approach of Policy Option 1, for two principal reasons. First, the reason for any direct costs arising will principally be because of a reduction in the perceived implicit government guarantee. So if the direct costs are significant, that is because the reduction in this guarantee is significant. And any policy which removes or reduces an implicit government guarantee – effectively, a subsidy – leads to a better alignment of risk and reward, reducing incentives for excessive-risk taking in financial markets and facilitating more efficient allocation of capital. And second, the indirect costs are minimal and the potential benefits from enhanced financial stability more broadly are very significant.

WIDER IMPACTS

One In One Out Policy

96. This policy is out of scope of the Governments One In One Out policy as it deals with systemic financial risk.

Equalities Impact

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

Justice Impact

98. The Government considers that these proposals will not have an impact on the courts including claims on legal aid.