Regulatory Policy Committee	**Opinion**	
Impact Assessment (IA)	Banking reform: ring-fencing secondary legislation	
Lead Department/Agency	HM Treasury	
Stage	Final	
IA number	Not provided	
Origin	Domestic	
Expected date of implementation	SNR 8	
Date submitted to RPC	06 June 2014	
RPC Opinion date and reference	02 July 2014	RPC14-HMT-2126
Departmental Assessment		
One-in, Two-out status	**Out of Scope**	
Estimate of the Equivalent Annual Net Cost to Business (EANCB)	**N/A**	
RPC Overall Assessment	**GREEN**	

RPC comments

The IA is fit for purpose. The Department explains the proposal is out of scope of One-In, Two-Out (OITO) as it is specifically intended to reduce systemic risk in the UK banking sector.

The proposal follows extensive policy development and consultation by both the Independent Commission on Banking (ICB) and Government over a period of four years.

The Department expects the overall benefits of ring-fencing to outweigh the costs of the measure following the removal of the implicit government guarantee to the banking sector. Bank costs are estimated to be in the region of £1.8-3.9 billion each year in addition to one-off transitional costs of £0.5-3.0 billion. The proposal contains a *de minimis* exemption that excludes small and micro businesses from the measure.

Background (extracts from IA)

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

"[B]*anks 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'…This is to be achieved by requiring the ring-fencing of retail deposit-taking services…from wholesale/investment banking. This will insulate essential retail banking services from shocks originating elsewhere in the financial system, and…will reduce the likelihood of public funds being needed to rescue a failing bank."

Comments on the robustness of the OITO assessment

The IA states that the proposal will result in greater financial stability, benefiting the UK economy as a whole. UK retail banking services will be better insulated against financial shocks, and the authorities will be better able to manage the failure of banks without recourse to public funds. The Department says the measure is out of scope of OITO on the basis that its purpose is to tackle financial systemic risk. This assessment is reasonable and is consistent with paragraph 1.9.8 v. of the Better Regulation Framework Manual.

Comments on the robustness of the Small & Micro Business Assessment (SaMBA)

The ring-fence applies to all banking groups with total retail deposits of £25 billion or more. The Department confirms that no small or micro businesses would be adversely affected by the proposal. The Department has commented that reducing the perceived implicit guarantee would reduce the competitive disadvantage currently faced by small banks and should support greater competition in the market.

Although the Department did not provide a separate SaMBA, the RPC considers the analysis to be sufficient in this case. As the measure includes a *de minimis* exemption, small and micro businesses will not be directly affected. However, as customers of banks, many small businesses may be affected indirectly. The Department's IA could be improved by including a fuller assessment of the impact on small business customers and any indirect effects on smaller banks outside the ring-fence.

Quality of the analysis and evidence presented in the IA

The Department explains that the ring-fencing of retail from wholesale/investment banking is central to the Government's structural reforms to UK banks. Ring-fencing was a key recommendation of the ICB, which also considered a range of alternative reforms including full separation of retail from investment banking, narrow banking and full reserve banking. The IA could be improved by including a narrative explaining the impacts on a bank of being inside or outside of the ring-fence.

The Department has identified the following costs resulting from the measure:

- Banks will incur upfront costs of restructuring, such as the costs of establishing new subsidiaries. The Department estimates one-off costs of £100-600 million per bank, giving a range of £0.5-3.0 billion for the industry.
- As a result of operating additional legal entities, banks will face ongoing administrative costs, such as operating separate IT platforms. The Department estimates these costs to be £30-105 million per bank per year, giving a range of £270-570 million for the industry.
- The principal economic cost to UK banks of ring-fencing comes from the reduction in the perceived implicit government guarantee enjoyed by banks seen as 'too big to fail'. The guarantee acts to lower the banks' cost of funding as well as the level of capital the market requires them to hold. The Department estimates that, as a result of the reduction in the guarantee, the banks will face additional capital costs in the range £1.1-2.3 billion each year and additional funding costs of £0.4-1.1 billion each year. These estimates came from extensive scenario modelling undertaken by the major UK banks affected by the measure.

Faced with higher costs, banks may choose to pass these costs on to customers by increasing the price of credit offered to individuals and businesses. This, in turn, could affect consumption and investment and result in a gross reduction in the long-run level of GDP. All else being equal, the Department estimates this to be equivalent to an average annual cost of £0.4-2.2 billion, resulting in lower annual tax receipts of £150-750 million each year.

The Department expects ring-fencing to reduce the likelihood of bank failure, by making banks more resilient to shocks and reduce the impact on the economy and public finances in the event of a bank failure. While it is difficult to quantify the benefits of the measure, the Department provides an illustrative calculation to give a sense of scale of the benefits. The Department assumes that ring-fencing accounts for 25% of the total effect of financial sector reform. On this basis, ring-fencing would yield an economic benefit of 0.54% of GDP, equivalent to £8.8 billion in 2013 terms, each year.

The ring-fencing proposal has been developed over a number of years and has been subject to consultation both by the IBC and the Government. The Department has presented robust estimates of the costs and benefits of the proposal based on analysis undertaken by the industry. The Committee is satisfied that, on the basis of the evidence presented in the IA, the benefits of ring-fencing are expected to outweigh the costs. Nevertheless, the IA could be improved by clarifying the basis of a number of assumptions made in the analysis. These include the assumption that the Government's financial sector reforms reduce the likelihood of a crisis by 40% and that ring-fencing accounts for 25% of the overall impact.

Signed **Michael Gibbons,** Chairman