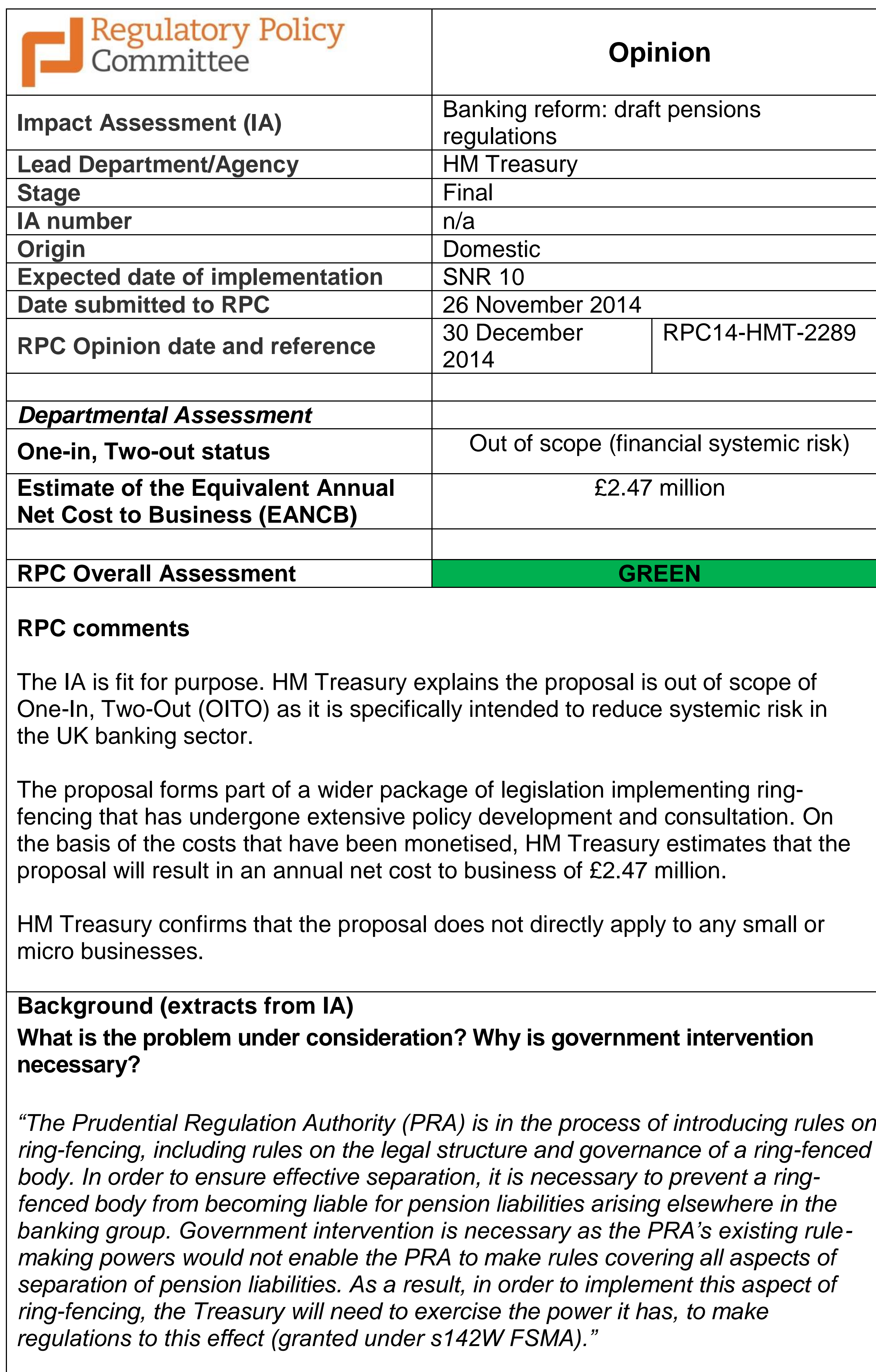

Regulatory Policy Committee	**Opinion**	
Impact Assessment (IA)	Banking reform: draft pensions regulations	
Lead Department/Agency	HM Treasury	
Stage	Final	
IA number	n/a	
Origin	Domestic	
Expected date of implementation	SNR 10	
Date submitted to RPC	26 November 2014	
RPC Opinion date and reference	30 December 2014	RPC14-HMT-2289
Departmental Assessment		
One-in, Two-out status	Out of scope (financial systemic risk)	
Estimate of the Equivalent Annual Net Cost to Business (EANCB)	£2.47 million	
RPC Overall Assessment	**GREEN**	

RPC comments

The IA is fit for purpose. HM Treasury 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 forms part of a wider package of legislation implementing ring-fencing that has undergone extensive policy development and consultation. On the basis of the costs that have been monetised, HM Treasury estimates that the proposal will result in an annual net cost to business of £2.47 million.

HM Treasury confirms that the proposal does not directly apply to any small or micro businesses.

Background (extracts from IA)

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

"The Prudential Regulation Authority (PRA) is in the process of introducing rules on ring-fencing, including rules on the legal structure and governance of a ring-fenced body. In order to ensure effective separation, it is necessary to prevent a ring-fenced body from becoming liable for pension liabilities arising elsewhere in the banking group. Government intervention is necessary as the PRA's existing rule-making powers would not enable the PRA to make rules covering all aspects of separation of pension liabilities. As a result, in order to implement this aspect of ring-fencing, the Treasury will need to exercise the power it has, to make regulations to this effect (granted under s142W FSMA)."

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What are the policy objectives and the intended effects?

"The intended effect of ring-fencing and the overall policy objective is to ensure that ring-fenced banks can continue to operate in the event of the failure of other entities in the group. Under current pensions legislation, a ring-fenced bank may become liable for the pension burden of other members of the group in the event of their failure. This would undermine the effectiveness of the policy of ring-fencing. The intended effect of the Regulations is to ensure that ring-fenced banks are not, and cannot become, liable for pension liabilities of other bodies."

Comments on the robustness of the OITO assessment

HM Treasury considers the separation of pension liabilities to be fundamental to the effectiveness of ring-fencing. It explains that the primary aim of the measure is to protect core financial services from shocks occurring elsewhere in the global financial system. HM Treasury 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 proposals increase the scope of regulation on business. A SaMBA is, therefore, required.

The SaMBA is sufficient. HM Treasury confirms that the proposal does not directly apply to any small or micro businesses and these businesses will remain unaffected. However, the department recognises that these firms may be indirectly affected in one of two ways.

First, the proposal may result in an increase in banks' private costs that may be passed on in higher lending costs. Smaller businesses may be more adversely affected by an increase in bank lending costs than larger businesses if they find it more difficult to access funds from alternative sources. However, HM Treasury expects the banks to offset these costs in other ways and hence the impact on lending costs is expected to be minimal. Second, ring-fencing of UK banks is expected to be pro-competitive as it is expected to reduce the competitive disadvantage of smaller banks by reducing the perceived implicit guarantee for large UK banks. This increased competition in the market should work to the benefit of small and micro businesses according to the IA. Although the IA states that the overall indirect effect on small and micro businesses is unclear, HM Treasury does not expect the impact to be significant.

Quality of the analysis and evidence presented in the IA

HM Treasury proposes to introduce regulations that require ring-fenced banks to ensure that they are not, and cannot become, liable for the future pensions liabilities of entities that are not ring-fenced banks. These regulations implement

the Independent Commission on Banking (ICB) recommendations that ring-fenced banks should be economically independent of the rest of their corporate group, and should not be liable for funding any deficit in any group-wide pension schemes.

This proposal is part of a wider package of legislation implementing ring-fencing. The deadline for banks to comply with ring-fencing is 2019, and the deadline for banks to have made the required changes to their pension liabilities is 2026. The proposal has been assessed over a 30-year period.

The IA explains that the government intends to give banks and their trustees a high degree of flexibility over how they undertake the restructuring required. HM Treasury has identified two principal costs:

1. The weakening of the employer covenant[1] will result in banks having to increase contributions to their pension schemes. While this will not impact on a bank's ability to lend, each bank will have to account for the loss of liquidity. Based on historical data, HM Treasury estimates that across all six banks the cost of meeting these liquidity requirements will be in the high tens of millions or the very low hundreds of millions. It expects these costs to be faced by banks over the next 10 to 20 years.

2. There will be one-off administrative costs, such as legal, actuarial and administration costs. The industry has estimated these costs to be no more than £50 million and will be spread over 10 years.

The IA also explains that the magnitude of the initial separation costs as a result of the proposal are dependent on whether section 75 is triggered or not. Under section 75 of the Pensions Act (1995), an employer withdrawing from a pension scheme which is in deficit, may be required to pay into the scheme compensation for giving up its liabilities to the scheme.

The IA explains that should s75 be triggered, it could lead to a transfer where one part of the banking group makes a payment to the pension scheme of another part of the banking group or vice versa. The cost to the banking group as a whole of having to pay any s75 debt will therefore be the admin costs of making the payment and the subsequent impact of a redistribution of capital within the group. However, the IA explains that the exact nature of any potential s75 liability is uncertain as it depends on how each pension scheme is restructured and the resulting negotiation between banks and trustees on the value of any payment. Given the uncertainties of whether section 75 will be used and the size of any debts, it has not been possible for HM Treasury to quantify the cost to the banks of meeting these debts.

In addition, HM Treasury expects the Prudential Regulatory Authority (PRA) to incur costs of approximately £1 million each year, for enforcing and policing the ring fence in relation to this proposal. It also expects the Pensions Regulator to incur costs, estimated to be £1.3 million. HM Treasury, therefore, estimates the

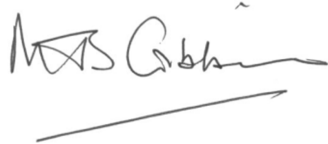
[1] The 'employer covenant' is a term used to describe an employer's legal obligation to a pension scheme and its ability to fund the pension scheme now and in the future.

proposal will result in total net costs of £61.1 million, in present value terms.

In the absence of the proposal, HM Treasury considers there would be a risk that a healthy ring-fenced bank could, in the event of another group company failing, be threatened by its pension liabilities. HM Treasury has not been able to identify the benefits of this particular aspect of ring fencing from the benefits of financial stability of ring-fencing as a whole (estimated to have a net benefit of £145 billion). Nevertheless, it expects the impact to be significant, as the banks' pension liabilities are estimated to be in the tens of billions of pounds.

HM Treasury submits that it would not be proportional to obtain more detailed figures on the costs and benefits of the proposal. Based on the evidence presented, the RPC agrees with this assessment.

This measure will be reviewed alongside the rest of the ring-fencing legislation in 2021 and, depending on the number of banks that have restructured their pension schemes at this time, may require a further review at a later date.

Signed  **Michael Gibbons,** Chairman