



HM TREASURY



Department  
for Business  
Innovation & Skills

# Banking reform:

a new structure for stability  
and growth

---



# Banking reform:

a new structure for stability and growth

---

Presented to Parliament by the  
Financial Secretary to the Treasury  
by Command of Her Majesty

February 2013

© Crown copyright 2013

You may re-use this information (excluding logos) free of charge in any format or medium, under the terms of the Open Government Licence. To view this licence, visit <http://www.nationalarchives.gov.uk/doc/open-government-licence/> or write to the Information Policy Team, The National Archives, Kew, London TW9 4DU, or e-mail: [psi@nationalarchives.gsi.gov.uk](mailto:psi@nationalarchives.gsi.gov.uk).

Where we have identified any third party copyright information you will need to obtain permission from the copyright holders concerned.

Any queries regarding this publication should be sent to us at: [public.enquiries@hm-treasury.gov.uk](mailto:public.enquiries@hm-treasury.gov.uk).

This publication is also available on <http://www.official-documents.gov.uk/>

ISBN: 9780101854528  
PU1443

Printed in the UK by The Stationery Office Limited on behalf of the Controller of Her Majesty's Stationery Office

Printed on paper containing 75% recycled fibre content minimum

# Contents

---

		Page
Chapter 1	Introduction	3
Chapter 2	Government response to the Parliamentary Commission on Banking Standards	5
Annex A	Impact assessment	29
Annex B	Regulatory Policy Committee's certificate	57

# 1

## Introduction

---

### Banking reform

**1.1** Banking reform is the second key pillar of the Government's programme for reform of the financial sector to address the weaknesses exposed by the financial crisis of 2007-09. The first pillar of this programme, reform of financial services regulation, has been legislated in the Financial Services Act that received Royal Assent in December 2012.

**1.2** The Government is now legislating to reform the structure of the UK banking system, through the Financial Services (Banking Reform) Bill, which was introduced to Parliament on 4 February 2013. The Bill implements key recommendations of the Independent Commission on Banking, including ring-fencing retail deposits from wholesale banking activities and depositor preference. The Government will also undertake further consultation this year on introducing a regulatory model for payment systems, with a particular focus on safeguarding the interests of new entrants and challenger banks.

### Response to the Parliamentary Commission on Banking Standards

**1.3** This document accompanies introduction of the Bill. It includes the Government's response to the first report of the Parliamentary Commission on Banking Standards (PCBS), which conducted pre-legislative scrutiny on the draft Bill published in October 2012. The response explains where the Government has amended the Bill in response to the PCBS's recommendations, or will do so during the Bill's passage through Parliament. This document also includes an impact assessment for the Bill, along with the opinion of the independent Regulatory Policy Committee.

# 2

# Government response to the Parliamentary Commission on Banking Standards

---

## Introduction

**2.1** The Parliamentary Commission on Banking Standards (PCBS), a joint committee of both Houses of Parliament, was formed in July 2012, to consider professional standards and conduct in the UK banking sector. The PCBS also considered the draft Financial Services (Banking Reform) Bill published by the Government in October 2012. The PCBS published its report on the draft Bill, and recommendations for legislative action, on 21 December 2012.

**2.2** **The Government welcomes the report of the PCBS, and thanks its members for their work.** The PCBS's analysis, advice and recommendations have been invaluable in developing and taking forward the Government's plans for implementing the recommendations of the Independent Commission on Banking (ICB), which is the main objective of the Banking Reform Bill. Having carefully considered the recommendations of the PCBS, the Government has decided to make a number of significant changes to its plans for ICB implementation. Some of these changes have already been incorporated into the Bill, others will be made by Government amendment to the Bill during its passage through Parliament.

**2.3** This document sets out each of the PCBS's recommendations in full, and the Government's response.

## Recommendations and responses

**2.4** The following sections set out the PCBS's recommendations on:

- Principles of ring-fencing;
- Pressing ahead with legislation;
- Principles-based regulation;
- Ensuring compliance with the ring-fence;
- Location of the ring-fence;
- Loss-absorbency; and
- Other recommendations.

## Principles of ring-fencing

**2.5** The Government welcomes the PCBS's endorsement of the principle of structural separation of retail from wholesale banking activities:

*The Commission finds the evidence that it has received on the benefits for financial stability of some form of separation convincing. The evidence that there has been damage*

*to standards and culture by having these activities side by side, an area not examined by the ICB, is comprehensive and a crucial consideration. There is evidence to suggest that, as well as supporting financial stability and reducing the risk to the taxpayer, separation has the potential to change the culture of banks for the better and to make banks simpler and easier to monitor. These are propositions to which the Commission expects to return in the New Year. (Paragraph 45)*

*There is widespread, but not universal, support for structural separation in some form. However, views in evidence to the Commission about how separation should operate, where a ring-fence should be placed and indeed whether ring-fencing can achieve the desired policy aims, fell well short of consensus. (Paragraph 80)*

*Whatever their views on arguments for and against full separation, which are finely balanced, the majority of witnesses told the Commission that the partial structural separation of the ring-fence would probably bring significant benefits for public policy and for banking. The Commission therefore welcomes the Government's action to bring forward legislation to implement a ring-fence. (Paragraph 93)*

**2.6** The Bill will require the ring-fencing of 'core' retail deposits from 'excluded' wholesale and investment banking activities. **The Government also strongly agrees with the PCBS that the overall objective of banking reform should be to curtail any perceived implicit guarantees enjoyed by banks seen as 'too big to fail'**, by helping to ensure that failing banks can be resolved without recourse to public funds:

*A guarantee, whether implicit or explicit, distorts incentives of managers and creditors, encouraging them to pursue excessive risk and leverage. It also distorts competition, and the allocation of resources, away from smaller banks to those large enough to be regarded as systemic. These problems are not removed simply by limiting guarantees to ring-fenced banks. While ring-fenced banks will carry out the majority of essential economic functions which need protecting, it is important to be clear that it is these functions that enjoy protection and not the bank itself or its shareholders or creditors. There should be no government guarantee of ring-fenced banks, nor perception of one. Neither does ring-fencing mean that risks from non-ring-fenced banks can be ignored, as such institutions will remain systemic and difficult to resolve. The stated aim of public policy, endorsed by the Commission, should be to reach a position in which a failing bank, whatever side of the ring-fence it may be, can be resolved without risk to financial stability or to public funds. The measures that we have considered in this Report fall well short of fulfilling this aim. The issues of banks which are 'too-big-to fail' and of investment banks in whatever country whose failure would pose systemic risks to the UK banking system are ones which will require further measures and to which the Commission will return in the New Year. (Paragraph 104)*

*A ring-fence alone does not make banks resolvable. Without wider reforms, it is possible that a ring-fence would simply result in one too-big-to-fail bank becoming two such banks, the failure of either of which would require taxpayer support to avoid major disruption. The resolution challenges of non-ring-fenced banks in particular should not be ignored. Of the measures still needed in order to make banks resolvable, ring-fencing and bail-in are the two most important. The draft Bill seeks to deliver a ring-fence and introduces some elements which will support bail-in, although this tool is mostly being delivered through the EU Recovery and Resolution Directive. (Paragraph 107)*

**2.7** The Government agrees with the PCBS that no bank should benefit from implicit government support, and has committed, along with the rest of the G20, to removing any perceived implicit government guarantees to the banking sector. Ring-fencing will play an

essential role in meeting this commitment, by increasing resolution authorities' ability to maintain the continuity of essential retail banking services in the event that a bank fails, without recourse to public funds. It is important to note that the continuity provision included by the Bill in the objectives of the regulator applies to core services in the UK, not to individual institutions, which will be allowed to fail as long as continuous provision of core services can be maintained. Ring-fencing will also increase the resolvability of banking groups, by allowing the authorities to pursue more tailored resolution strategies to different parts of a failing group.

**2.8** The Government recognises, however, that ring-fencing will not solve all of the problems in the financial sector, and that as the PCBS points out there is in particular more to be done to address the challenges of resolving entities that principally conduct investment banking activities. This is why, following a consultation in August 2012 into extending resolution powers to cover investment firms and other non-bank institutions,<sup>1</sup> the Government brought forward legislation in the Financial Services Act 2012. The Financial Services Act, which received Royal Assent in December 2012, extends the Special Resolution Regime in the Banking Act 2009 to investment firms, UK recognised clearing houses and to certain undertakings which are in the same group as a bank, investment firm or a UK clearing house. In addition to domestic legislation, the Government continues to press for the implementation of the Financial Stability Board (FSB)'s *Key Attributes for Effective Resolution Regimes* through the EU Recovery and Resolution Directive (RRD).

## Pressing ahead with legislation

*Compared with other EU Member States, the banking sector represents a very large part of the UK economy. It is important that measures to strengthen the stability and resolvability of UK-based banks are put in place on a timetable that best meets the need of UK public policy. The UK cannot wait for or rely on appropriate implementation of the Liikanen proposals. It is desirable to maximise compatibility between the banking reforms to be enacted in the UK and the EU. The task of obtaining agreement across twenty-seven countries might also lead to a long delay in implementation. This could create uncertainty for public policy and for banks. The Commission has therefore concluded that the prospect of EU legislation arising from the Liikanen proposals should not be a determining factor in deciding upon the appropriate timetable for or substance of UK legislation, which should be proceeded with on a timetable that meets the needs of the UK economy. (Paragraph 111)*

*The timetable for scrutinising the draft Bill which was arbitrarily dictated by the Government has meant that we have been unable to do justice to all of the issues which arise out of the draft Bill and related policy measures. We are concerned that the Government has constrained the ability of Parliament to conduct full scrutiny of a Bill of such vital importance. (Paragraph 12)*

**2.9** Ensuring that all legislation necessary to implement the recommendations of the ICB is in place by the end of the current Parliament is a key Coalition commitment, as announced by the Chancellor of the Exchequer and the Secretary of State for Business, Innovation and Skills in December 2011. The Government's legislative timetable has been driven by the need to meet this commitment, which was also in line with the ICB's own recommendations on the timescale for legislation. As the PCBS recognises, given the size of the UK banking sector relative to the economy, and given the risks of instability that regulatory uncertainty can create, it is essential that the Government presses ahead with legislating for the structural reforms recommended by

---

<sup>1</sup> HM Treasury, 2012, Financial sector resolution: broadening the regime:  
[http://www.hm-treasury.gov.uk/d/condoc\\_financial\\_sector\\_resolution\\_broadening\\_regime.pdf](http://www.hm-treasury.gov.uk/d/condoc_financial_sector_resolution_broadening_regime.pdf)

the ICB. Publishing the Bill in draft for pre-legislative scrutiny gave Parliament an additional opportunity to scrutinise the Bill before the legislative process began.

## **Publication of secondary legislation**

*There is a good case for placing technical detail in secondary rather than primary legislation, in particular because of the importance of “future proofing” to allow a flexible response to developments in the banking sector. However, given the evidence we received about past regulation being too much of a negotiation between banks and regulators, we do not believe that too much of the burden of defining the ring-fence should be left to regulators. It is important that legislation properly equips the regulator with the clarity and authority necessary to maintain the ring-fence. The Commission is concerned that the heavy reliance on secondary legislation leaves open too many questions of significant policy importance. It would be unacceptable if the Commission’s work in considering the framework were not matched by adequate scrutiny of the policy detail which follows in secondary legislation. This is not simply a parliamentary issue; it matters most because it creates uncertainty for the regulators who will be charged with making the new framework operational and for the banks required to operate within it. The Commission considers steps that could be taken to address these concerns through changes to the primary legislation in the next chapter. In the meantime, the Commission welcomes the firm commitment of the Chancellor of the Exchequer given in evidence to the Commission to “faithfully implement” the relevant measures of the ICB Report, subject only to previously identified exceptions. However, Parliament should not be expected to rely on his assurances alone. It is for this reason that the Commission makes specific recommendations about the timetable for parliamentary consideration and scrutiny of the forthcoming primary legislation and the accompanying draft secondary legislation. (Paragraph 122)*

*The absence of secondary legislation has seriously impeded the Commission in discharging the task which we have been set by the two Houses of Parliament. In view of the fact that the Treasury has been committed to publishing the primary legislation to enable effect to be given to the ring-fence since at least May 2012, the Commission finds it regrettable that further thought was not given at an earlier stage to the effects of the timing of draft secondary legislation on the process of pre-legislative scrutiny and the wider process of preparing for implementation. Without further information about the secondary legislation, it is not possible for this Commission to assess with any certainty how faithfully the Bill will give effect to the ICB recommendations. The jury is still out on the question of whether the Bill will implement those recommendations in letter and spirit. (Paragraph 123)*

*The Commission notes the commitment to publish the principal secondary legislation in draft in time for the Commons Committee stage, but considers it inadequate. The Commission strongly recommends that the Government publish the principal secondary legislation giving effect to the ring-fence at the time the Bill itself is published. This is essential to provide a reasonable opportunity for its consideration by regulators and by others directly affected, as well as Parliament. In the absence of their views, parliamentary consideration by relevant Committees and in the two Chambers will inevitably be of very limited value. This would be unacceptable in the case of legislation of such importance. (Paragraph 124)*

*The Commission has not received evidence to call into question the appropriateness of a 2019 deadline for full implementation of the ring-fence. The extended timetable for implementation creates a risk of erosion even before the ring-fence is first put in place. This reinforces the need for a high level of transparency during the implementation phase.*

*In addition, the primary concern of Government, Parliament, regulators and the affected institutions should be on getting the new legislation right. The Commission is not persuaded that immediate introduction of the primary legislation and its passage through the two Houses on a normal timetable would best serve this greater interest, given that much of the substance will reside in secondary legislation which should be available in draft. The Commission strongly recommends accordingly that, if the Government proceeds with publication of the Bill before the February 2013 half-term recess, there be a period of three sitting months between the second reading of the Bill in the House of Commons and the commencement of the Committee stage. The Commission would expect a pause prior to Committee stage of at least two sitting months even if the Bill is published later than mid-February. (Paragraph 125)*

**2.10 The Government agrees with the PCBS that much of the detail of the reforms should be set out in secondary legislation**, in order to allow the regulatory regime the flexibility to adapt to innovation in financial services and markets. As discussed above, the Government also agrees that regulators should be given greater guidance on the face of the statute to assist them in making rules to implement ring-fencing and in particular in setting the height of the ring-fence, and has amended the Bill to that effect. To assist Parliamentary scrutiny of the Bill, the Government will by the Bill's Commons Committee stage publish drafts of the principal statutory instruments, including those establishing the scope of the ring-fence, the de minimis exemption from ring-fencing, the specific prohibitions on ring-fenced banks, and the precise conditions for exemptions. However, the Government will not delay the Bill's passage through Parliament, as to do so could endanger the Coalition's key commitment to ensuring that all legislation necessary to implement the ICB's recommendations is in place by the end of this Parliament.

### **Principles-based regulation**

**2.11** The PCBS highlighted the importance of ensuring that the ring-fence is robust against attempts by banks to subvert or undermine it.

*The characteristics of financial crises and the nexus between banks, politicians and regulators together pose fundamental challenges for the design and implementation of structural separation. Any framework will need to be sufficiently robust and durable to withstand the pro-cyclical pressures in a future banking cycle. Those pressures will include the siren voices of those who contend that structural separation as implemented represents a barrier to financial innovation and growth. Politicians need to face up to the possibility that they may prefer those siren voices to the precautionary approach of regulators, particularly if, once again, it appears that banks are performing alchemy. In the chapters that follow, we consider the approach needed best to ensure that structural separation is able to withstand these challenges. (Paragraph 78)*

**2.12 The Government agrees that it is essential to ensure that the framework is robust, and not susceptible to erosion over time.** The Government has taken steps to ensure that this is the case: the general objective of the Prudential Regulation Authority (PRA) will be amended to require the regulator to protect the continuity of core services; the Financial Conduct Authority will have an equivalent continuity objective in the event that it becomes responsible for the regulation of core activities, and the regulators will have a clear purpose to uphold when making rules concerning ring-fencing. The Government's discretion in creating core and excluded activities, and in permitting exceptions to them is constrained by the conditions on the exercise of the powers given to the Government which are set out in the Bill. In addition, **the Government agrees with the PCBS that further steps should be taken to ensure that the ring-fencing framework stands the test of time.** To that end, the Government has enhanced the level of Parliamentary scrutiny of the main statutory instruments which will provide the building blocks

for ring-fencing, and set out in more detail what requirements must be laid down in rules by the regulator to ensure the robustness of the ring-fence.

## Regulatory objectives and judgement

**2.13** The PCBS made specific recommendations on the objectives of the regulator with regard to ring-fencing, and the regulator's ability to exercise its judgement in pursuit of those objectives.

*The ICB final report sets out three, not one, objectives for the ring-fence. These are:*

- *make it easier to sort out both ring-fenced banks and non-ring-fenced banks which get into trouble, without the provision of taxpayer-funded solvency support;*
- *insulate vital banking services on which households and SMEs depend from problems elsewhere in the financial system; and*
- *curtail government guarantees, reducing the risk to the public finances and making it less likely that banks will run excessive risks in the first place.*

*The continuity objective does not adequately reflect these. In order to anchor implementation of the ring-fence more securely to the ICB's proposals, the Commission recommends that the Bill as introduced imposes additional requirements under the new section 2BA(4) of FSMA to ensure that in advancing the continuity objective, the PRA must also seek to meet the following requirements as set out in paragraph 1.3 of the policy paper accompanying the draft Bill, namely:*

- *Making banks better able to absorb losses;*
- *Making it easier and less costly to sort out banks that still get into trouble; and*
- *Curbing incentives for excessive risk-taking.*

*The continuity objective must be properly understood as being about protecting the continuity of the provision of core services, not about the continuity of institutions. The regulator seeks clarity about how the continuity objective relates to the other objectives of the regulator when exercising powers in relation to the ring-fence. The Commission will take further evidence and report on this matter in the New Year. (Paragraph 130)*

*In the light of recent revelations the Commission has taken evidence regarding the ability of the ring-fence to protect and enhance standards and culture in the banks and will consider in our final Report whether an additional objective should be considered to address these concerns. (Paragraph 131)*

**2.14** The Government agrees with the PCBS that the objectives of ring-fencing should be fully reflected on the face of the Bill, and that the relationship between the PRA's continuity objective and the regulator's other objective should be clarified. The Government has therefore amended the Bill to make the continuity objective part of the PRA's general objective. That is to say that maintaining the continuity of core services is one of the ways in which the PRA pursues its general objective. As a result of this change, it should be clear that ensuring continuity of (ring-fenced) core services is a central pillar of the PRA's general objective, and not an additional obligation.

**2.15** In order to provide clarity that the original ICB objectives are captured within the PRA's general objective, the PRA will be required to protect the continuity of core services in three ways, which reflect the ICB's three objectives for ring-fencing. The first is to ensure that ring-fenced bodies do not do anything that adversely affects the continuity of core services; this will include ensuring they do not take excessive risks. The second is to ensure that they are protected from external risks, in other words insulated from problems elsewhere in the financial system. And the

third is to ensure that their failure does not put at risk the continuity of core services, that is to ensure that it is possible to sort out failing banks, without recourse to taxpayer support. These reflect the ICB's objectives. The Government does not agree that any reference to making banks better able to absorb losses be included in the Bill; this is an important objective of the wider policy, for example with specific relevance for bail-in, but less relevant for ring-fencing.

*In addition to the enhanced scrutiny arrangements recommended later in this chapter, the Commission recommends that the Treasury's delegated powers under proposed sections 142A(2)(b) and 142D(2) be tightened. It is insufficient to require only that exemptions from the ring-fence restrictions do not have a "significant adverse effect on the continuity in the United Kingdom of the provision of core services". The fact that this condition is framed as a negative test could too easily allow a series of exemptions cumulatively to weaken and complicate the ring-fence, even if individually these fall short of risking a "significant adverse effect". The provisions should be tightened by requiring that exemptions should be made only if they:*

- *do not pose a risk to the continuity objective; and*
- *provide a significant economic or financial stability benefit. (Paragraph 135)*

**2.16 The Government agrees with the PCBS that the tests for exempting otherwise excluded or prohibited activities must be tough.** In response to the PCBS's particular concern regarding the tests for exemptions under sections 142A(2)(b) and 142D(2), the Government will consider further amendments to ensure that the tests deliver the policy intention.

*It is essential that the new framework for the ring-fence and the secondary legislation and rules that flow from it are not seen by the banks merely as a basis for negotiation. The legitimate role of the judgement of the regulator in implementing the framework must be beyond doubt. The regulator's decision-making, in line with its judgement in pursuit of its objective in relation to the ring-fence, should not require it to identify a specific breach of rules in order to take action to maintain the integrity of the ring-fence. The Commission considers that it is of paramount importance that the new legislation is drafted in such a way as to make this clear. (Paragraph 133)*

*The Commission is extremely concerned, as are the regulators themselves, that the key issues determining the height of the ring-fence are proposed to be a matter for determination by the regulator alone. A regulator enforcing rules of its own creation will have less authority in doing so than a regulator giving effect to a clear mandate in legislation with parliamentary authorisation. There is a compelling case for strengthening the regulator's hand when it makes ring-fencing rules through such a mandate. The Commission recommends accordingly that proposed section 142H of FSMA be amended either to define the parameters of the rules to be set by the regulator more fully or to require that secondary legislation made by the Treasury and subject to the affirmative resolution procedure defines the parameters. The objective of this legislation should be to empower the regulator to police and enforce the ring-fence. The Commission considers in chapter 10 what the legislative parameters should be. (Paragraph 139)*

*In the previous chapter, the Commission recommended that the core minimum requirements for a ring-fence of adequate height should be set out in secondary legislation subject to affirmative resolution procedure, and not be the subject of regulatory discretion. The Commission welcomes the Chancellor of the Exchequer's clear position on the key elements that should be included to ensure the proper independence of a ring-fenced bank. The Commission recommends accordingly that the initial secondary legislation made under proposed section 142H of FSMA (as envisaged in our recommendation in paragraph 139) should give the regulator a duty of ensuring operational independence for the ring-*

*fenced bank in respect of governance, risk management, treasury management, human resourcing, capital and liquidity. (Paragraph 224)*

**2.17** In his evidence to the PCBS, Andy Haldane, Executive Director for Financial Stability at the Bank of England, suggested that operational independence in the following areas was necessary to ensure that the objectives of ring-fencing could be delivered: governance, risk management, treasury management, human resourcing, capital and liquidity. **The Chancellor of the Exchequer confirmed that he agreed with this position in his evidence to the PCBS.** To put this beyond doubt, the Government has further amended the Bill to specify the areas in which operational and economic independence must be established. These are set out in an expanded section 142H. In addition, the Government has sought to clarify the purposes for which the regulator is required to make ring-fencing rules by clarifying the group ring-fencing purposes now set out in subsection (4) of 142H, and requiring the regulator to make any other provision it considers to be necessary or expedient to achieve those purposes. This will give the regulator an unambiguous mandate to deliver the degree of separation that the ICB envisaged. In addition, the Treasury will be able to give further clarity to the parameters which must be set in ring-fencing rules to ensure the independence of the ring-fenced body by imposing additional requirements on the regulator by Order.

### **Scrutiny of secondary legislation**

*The scrutiny arrangements for secondary legislation as specified in the draft Bill are unacceptably weak. Many of the delegated powers may involve significant policy choices, not merely implementation decisions of a technical nature. The Commission recommends that use of each of the delegated powers under proposed new sections 142B(5), 142D(2), 142D(4) and 142E should be subject to the affirmative resolution procedure. (Paragraph 146)*

*The Commission has concluded that the range of powers available to the Treasury under proposed section 142F is unacceptably wide. As a first step, the Commission recommends that the power of the Treasury to give itself further order-making powers be more fully circumscribed. In particular, there should be a requirement that the power further to delegate under secondary legislation a power to make what might be termed tertiary legislation should be subject to the same parliamentary procedure as the instrument by which the power to make it is delegated. The Commission also recommends that, in the delegated powers memorandum accompanying the Bill itself, the Government set out in more detail the proposed use of each of the additional delegated powers it is seeking in section 142F. (Paragraph 149)*

*The Commission has concluded that a necessary form of parliamentary bulwark against erosion is the creation of a specific statutory provision for enhanced parliamentary scrutiny of the proposed use of delegated powers which have the potential to change the location of the ring-fence in a significant way. This would apply to all uses of the powers referred to in paragraph 146, subject to exceptions for secondary legislation of an urgent nature, which should be subject to the 'made affirmative' procedure. This scrutiny would be undertaken by a small ad hoc joint committee of both Houses of Parliament, to be established on each occasion subsequent to the first use of each delegated power when the Treasury proposes to exercise one of those delegated powers. Although the membership of the joint committee would be determined by decisions of the two Houses, there should be a statutory requirement for the Chairman of the House of Commons Treasury Committee to be an ex officio member of it. (Paragraph 151)*

*The Government would be required to publish its case for the proposed new use of the power, alongside a provisional version of the secondary legislation itself. This provisional version would be subject to public consultation. The ad hoc joint committee would be*

*established at the outset of this consultation phase. It would examine and report on the proposal within a specified period. After that report, the Government could proceed with secondary legislation in the usual way, albeit subject to the affirmative resolution procedure in accordance with the Commission's recommendation in paragraph 146, but would do so in a way that secures far greater transparency about the purpose and likely effect of any changes. (Paragraph 152)*

**2.18** The Government agrees with the PCBS that secondary legislation made under the Bill should be subject to proper scrutiny, and has taken note of the views of the House of Lords Delegated Powers and Regulatory Reform Committee (DPRRC) and of the PCBS in relation to the level of Parliamentary scrutiny originally set for the exercise of the delegated powers provided for in the Bill. Accordingly, the Government has amended the Bill to provide for much greater use of the draft affirmative resolution procedure. This will now apply to orders made under:

- section 142A(2)(b) (exemptions of ring-fenced bodies);
- section 142B (when accepting deposits is not a core activity, and new core activities), 142D(2) (exceptions to the excluded activity of dealing in investments as principal);
- section 142D(4) (new excluded activities);
- section 142E (prohibitions);
- section 142K (regulations in relation to pensions);
- section 142I (requirements on the regulator to make ring-fencing rules in additional areas to achieve the ring-fencing objectives set out in s.142H(1)(b));
- section 142M (power in relation to loss absorbency requirements);
- clause 8 (power to make provision about ring-fencing in relation to building societies); and
- section 410A (fees to meet certain expenses of the Treasury, apart from an order made under section 410A(2)).

Where orders made under sections 142D(4) (new excluded activities) and 142E (prohibitions on ring-fenced bodies) are required as a matter of urgency, they will be subject to a made affirmative resolution procedure. Under this procedure they may be made without being laid before Parliament in draft, but must be approved by each House of Parliament after being made if they are to remain in force. Going beyond the recommendations of the DPRRC, the Government will also bring forward an amendment to make section 142C(3) (specifying new core services in relation to the core activity of accepting deposits) will be subject to the draft affirmative procedure.

**2.19** In line with the enhanced Parliamentary scrutiny of secondary legislation recommended by the Delegated Powers Committee, the negative resolution procedure will now only be used for:

- an order under section 142G(3) specifying the cases where a person who has suffered loss as a result of a contravention may bring an action for a breach of statutory duty;
- an order under section 410A(2) listing the international organisations within the scope of regulations under section 410A; and
- an order under clause 18 making transitional provisions or savings.

**2.20** In response to the concerns raised by the PCBS and the DPRRC, the Government has removed the power previously created under new section 142F for an order made under sections 142A, 142B, 142D or 142E to confer powers on the Treasury, to ensure that this provision cannot be used as a way of avoiding the need for parliamentary control. New section 142F now only permits powers to make rules or other instruments to be conferred on the regulator. In addition, the power in new section 142M(4) (which was new section 142J(4) of the draft Bill) to give the Treasury power to give directions to the regulators has been removed. The previous section 142K which contained a wide ‘Henry VIII’ power, has also been removed. The Government does not consider that an additional Parliamentary scrutiny process is necessary.

## Ensuring compliance with the ring-fence

### Enhanced regulatory powers

**2.21** The PCBS made recommendations for additional powers for the regulator over the corporate structure of banking groups, including reserve powers to require full separation of retail and wholesale banking activities.

*There is a strong case for the proposition that full structural separation would be the wisest course to take. As we noted earlier, Sir Mervyn King told us that he had “always felt that total separation was the right way ultimately to go” and that he was “glad that many more people are now coming on board with the idea that a move to some kind of serious separation is the right thing to do”. At the very least, it is essential that it remains a possibility. (Paragraph 162)*

*The ring-fence envisaged by the Government may, in the long run, not provide an adequate degree of separation. Nor may it be adequate to buttress banking standards. The role that separation might play in strengthening standards across the banking sector is a matter to which we will return in the New Year. The inadequacies of the framework may become apparent over time, as banks seek to test the strength of the ring-fence. The evidence received by the Commission from the current regulators, and to which we referred in chapter 5, highlighted the pressure which is likely to be exerted on the regulator by banks and by politicians to take steps consistent with short-term profitability and sectoral development, but inconsistent with the long-term objectives of the ring-fence. Additional powers are essential to provide adequate incentives for the banks to comply not just with the rules of the ring-fence, but also with their spirit. In the absence of the Commission’s legislative proposals to electrify the ring-fence, the risk that the ring-fence will eventually fail will be much higher. (Paragraph 163)*

*The regulator already has powers under section 45 of FSMA to require banks to cease certain activities in specified circumstances. The Commission believes that it is necessary to go further. The Commission recommends that the forthcoming legislation add reserve powers to implement full separation. (Paragraph 164)*

*The first reserve power would be a power exercisable in respect of individual companies. A second reserve power would relate to the sector as a whole and would be exercisable in consequences of the review to which we refer in paragraph 171. With regard to the first reserve power, the Bill should include powers for the regulator to take steps that could lead to a specific banking group affected by the ring-fence being required to divest itself fully of either its ring-fenced or its non-ring-fenced bank. The powers would be exercisable only if the regulator had concluded that the conduct of that banking group was such as to create a significant risk that the objectives of the ring-fence would not be met in respect of that bank. In these circumstances the regulator should consider the group’s adherence to the principles and spirit of the ring-fence as well as its compliance with the letter of the*

law. The Commission recommends that the objectives for this purpose should be aligned with those for the relevant work of the regulator set out on the face of the Bill, as amended from the draft Bill in accordance with our recommendation in paragraph 130. (Paragraph 165)

The Commission recommendation is of sufficient significance to require a number of limitations and safeguards. First, in order to allow time for the ring-fence to demonstrate its effectiveness, the Commission recommends that the Bill provides that the powers should not be exercisable by the regulator until after the completion of the first independent review of the effectiveness of the ring-fence that we propose in paragraph 171 and that we envisage should be completed less than four years after the ring-fence comes into force. The opportunity of this delay in commencement should also be taken by the Government to secure amendments to European legislation to ensure that the provisions relating to full structural separation are compatible with European law. (Paragraph 166)

The review mechanism currently included in the draft Bill is narrow and unacceptably weak. The Commission recommends an annual report from the PRA on the operation of the ring-fence. This is important to provide transparency on any issues arising between the regulator and banks and will give the regulator a vehicle for exposing attempts to game the system, get round or burrow under the ring-fence. The Commission recommends that the Bill be greatly strengthened. It should require a regular review of the effectiveness of the ring-fence across all banks to which the rules apply. The review body's terms of reference should require it to express a view on whether ring-fencing is achieving the objectives set out in legislation, and to assess the case for a move to full separation across the banking sector as a whole. The terms of reference for the review should be set out in statute, based on the objectives for the ring-fence as laid down in legislation. The review body should have a duty to make recommendations to the regulator and the Treasury about the design and application of secondary legislation and ring-fencing rules. Prior to that review, the Bill should require that the PRA publish a statement which summarises how the ring-fencing rules have been implemented by the industry with specific consideration being given to how the position of the ring-fence has evolved, primarily focusing on what activities and services, in addition to the core activities and core services, sit within the ring-fenced bank and to the type of derivative products are being offered by the ring-fenced banks. The review body should be able to draw upon the work conducted by the regulator as part of its statement on the position as it has evolved by then. If the first review does not lead to full separation, second and subsequent reviews should also draw upon the regulator's accounts of experience in relation to the first reserve power the creation of which the Commission has recommended. Significant use of this reserve power would indicate that full separation across the banking sector would be very likely to be the appropriate step. The independent review should take place within four years of the rules implementing the ring-fence taking effect, and regularly at an interval specified in statute of no more than five years. (Paragraph 171)

The review body should be independently-led in order to provide appropriate challenge to the Treasury and PRA, who may otherwise find it difficult to criticise their own involvement in designing the framework. We would expect the body to have a range of backgrounds and views comparable to that of the ICB, although we believe that it should also include a former very senior central banker or regulator. (Paragraph 172)

**2.22** The Government agrees with the PCBS that it is essential to preserve the robustness of the ring-fence, and that a reserve power to require an individual banking group to move to full separation of retail and wholesale activities could be a powerful additional tool for the regulator

to ensure the independence of a ring-fenced bank. **The Government will therefore amend the Bill to include provisions giving the regulator the power to enforce full separation between retail and wholesale banking in a specified group.** To ensure that such a substantial regulatory power is not used lightly, strict statutory conditions will be established setting out the circumstances in which this power can be used, tests that must be met and factors the regulator must take into account before deciding to require a group to separate. Given the potential wider economic impact of requiring a group to separate, as the PCBS recommended, any regulatory order to separate will also require approval from the Treasury. The Government will bring forward an amendment to the Bill to include the necessary provisions.

**2.23** The PCBS's recommendation for a reserve power for the regulator to require sector-wide separation is of a different nature. Rather than helping to maintain the integrity of the ring-fence, this proposal appears to be based on the presumption that the ring-fence will prove to be ineffective in delivering the financial stability benefits it is intended to achieve. The Government does not accept that ring-fencing will fail, but agrees with Sir John Vickers and the ICB that ring-fencing will yield benefits to financial stability while preserving the advantages that structured universal banking can bring. If in the future it became apparent that, due to developments in the nature of banking or other changes in circumstances, the ring-fence had become ineffective, then the Government would return to Parliament for a full debate on whether alternative structural changes were required. Given this, it is not necessary to legislate now for a reserve power to abandon ring-fencing at some point in the future. There would also be significant constitutional objections to a reserve power for the regulator to impose a radical change in the structure of the entire UK banking sector, and in effect to repeal most of the provisions of the Bill. In his evidence to the PCBS, Sir Mervyn King argued that such a 'sword of Damocles' should not be placed in the hands of regulators. The Government agrees that it is not appropriate to leave decisions over the fundamental structure of banking in the UK to the regulator: such decisions should be for the Government and Parliament, to ensure proper democratic accountability.

**2.24** It is standard regulatory practice for the Government to conduct a review of all new regulations once they have come into effect. The Government will, therefore, monitor the ring-fence and its effectiveness in achieving its objectives on a continuous basis once it has been established. To support this ongoing monitoring, **the Government will require the PRA to conduct annual reviews of the operation of the ring-fence,** as the PCBS recommends.

*The Commission found that the arguments for prohibiting a non-ring-fenced bank from directly owning a ring-fenced bank are persuasive. This is a clear and straightforward way to strengthen the ring-fence, and is far better done at the outset. The Commission recommends accordingly that the regulator be given the power to require a sibling structure between a ring-fenced and non-ring-fenced bank, with a holding company. The Commission would expect this power to be exercised. (Paragraph 228)*

**2.25** The Government agrees that the corporate structures of banking groups should not undermine the effectiveness of the ring-fence, or the resolvability of the group. The Government expects, however, that under the EU RRD regulators will be given substantial powers to require reorganisations necessary to achieve resolvability, and the reserve power to require full separation will further enhance the regulatory toolkit. Given this, the Government does not at this stage believe it necessary to provide for further powers (beyond those recommended by the ICB) to restrict groups' corporate structure.

### **Directors' duties**

**2.26** To support the independence of ring-fenced banks from their wider corporate group, the PCBS made recommendations on the statutory duties of bank directors.

*There is likely to be a tension between the integrity of the ring-fence and the duties that directors of ring-fenced banks will owe to the parent company and through them to shareholders. This tension will be present regardless of whether directors of the ring-fenced bank are employed elsewhere in the group. It is not possible under current company law to create a subsidiary which is entirely independent. The Commission recommends that the Government insert within FSMA a legal duty on boards of directors to preserve the integrity of the ring-fence. (Paragraph 222)*

*The Commission further recommends that the Government set out, in its response to this Report, a full account of how directors would be expected to manage the relationship between such a duty and their duties to the shareholders. The Commission considers that an element of conflict between the duties may be unavoidable, and that this will constitute a permanent challenge for any structural solution which falls short of full structural separation. (Paragraph 223)*

**2.27 The Government agrees with the PCBS that independent governance is an essential part of ensuring the legal, economic and operational independence of ring-fenced banks** from their wider corporate groups, and that directors of ring-fenced banks should be personally responsible for ensuring that their banks comply with ring-fencing provisions. This will be delivered through the approved persons regime, as amended by the Financial Services Act 2012. The Banking Reform Bill will further amend the Financial Services and Markets Act 2000 (FSMA) to ensure that a director of a ring-fenced body must always be an approved person.<sup>2</sup> This ensures that any director of a ring-fenced bank who is knowingly concerned in a contravention by a ring-fenced bank of any of the ring-fencing obligations set out in the Bill, or in Orders made by the Treasury or ring-fencing rules made by the regulator under the Bill, will be subject to the full range of the regulators' disciplinary powers (which may in serious cases include lifelong suspension and/or with very large fines). In addition, the Government will take into account any further recommendations that the PCBS makes in relation to directors' liability and sanctions during the passage of the Bill.

**2.28** The PCBS asked the Government to set out how any possible conflict of interest between the duties of the director of a ring-fenced bank and duties to shareholders would be managed. As a matter of law, directors of any company have a fiduciary duty to promote the success of the company for the benefit of the shareholders, not a separate or independent duty to shareholders. This means that bank directors must take decisions that are in the long-term interests of the bank. This duty is entirely consistent with the directors' specific duty to comply with ring-fencing rules, as envisaged by the legislation.

## **Location of the ring-fence**

**2.29** The PCBS made a number of recommendations relating to the location of the ring-fence, that is the activities that should either be required within, or excluded from, ring-fenced banks.

## **Derivatives**

*Allowing ring-fenced banks to sell derivatives other than as an agent creates additional prudential and conduct risks. There are genuine concerns that this may lead over time to the sale by ring-fenced banks of more complex and risky products. The larger and more complex the derivative book, the more of a threat it could pose. (Paragraph 191)*

---

<sup>2</sup> See clause 5 of the Bill.

*The effects on consumers of allowing or prohibiting certain derivatives from being sold by ring-fenced banks as principal are uncertain. Banks have argued that a prohibition would result in consumer detriment, but selling derivatives to SMEs has been a highly profitable activity for them and investigations of mis-selling of interest rate swaps demonstrate the risk this poses to trust between banks and their customers; if ring-fenced banks were limited in their ability to provide these products directly it is plausible that the wider market would evolve and that other providers would compete to pick up the business to the benefit of consumers. The control of the sale of derivatives to prevent mis-selling is a matter of fundamental importance, to which the Commission will return in the New Year, but it is far from evident that the use of a structural solution (preventing ring-fenced banks from acting as principal) would be the best tool to deal with this issue. (Paragraph 192)*

*The sale of derivatives within the ring-fence poses a risk to the success of the ring-fence. The Commission has concluded that there is a case in principle for permitting the sale of simple derivatives within the ring-fence. However, such permission would need to be subject to conditions. The first is that there are adequate safeguards to prevent the mis-selling of derivative products within the ring-fence, a matter to which the Commission will return in the New Year. The second is that "simple" derivatives can be defined in a way which is limited and durable, a matter we consider in the next paragraph. The third is that there are limits on the proportion of a bank's balance sheet which is allowed to be taken up by these products. We remain concerned that allowing these products within the ring-fence may be the thin end of a wedge which could undermine the ring-fence. (Paragraph 193)*

*In addition to the elements of a "simple" derivative already identified by the Treasury, it is essential that there is a requirement that the size, maturity and basis of simple products should be limited to hedging the underlying client risk. The definition of 'simple derivatives' must appear in legislation. The Commission recommends that the proposed initial definition should be provided to the Treasury Committee before the Bill has completed its Commons stages. Whatever definition is chosen in the first instance, the banks will argue, as certain banks argued to this Commission, that customers would benefit from broadening the definition. For this reason, the Commission recommends that the regulator be required to report annually to Parliament on the extent and nature of the sale of derivatives within the ring-fence, including the effects of any changes to secondary legislation proposed by a future Government. (Paragraph 194)*

*The Government's proposals to limit the prudential risks arising from derivatives activity, such as limiting net market exposure to a small percentage of capital, are important and necessary. However, this would not limit the absolute volume of derivative activity. A large derivatives portfolio would still pose an unacceptable risk to the stability and resolvability of ring-fenced banks, even if it is supposedly hedged and collateralised. It could also affect the culture of the bank in an undesirable way. The Commission recommends accordingly that the Government impose an additional cap on the gross volume of derivative sales for ring-fenced banks, and on the total value of derivatives used for hedging. The Commission would expect consultation to take place before determining how a gross cap should be measured. (Paragraph 195)*

**2.30 The Government agrees with the PCBS that in principle ring-fenced banks may be permitted to sell certain simple derivatives to their customers**, subject to strict safeguards to ensure that derivatives do not undermine the resolvability of ring-fenced banks, and to guard against mis-selling. The conditions under which ring-fenced banks may enter into derivatives contracts will be governed by secondary legislation. The Government will ensure that the recommendations of the PCBS regarding the safeguards necessary are reflected in the secondary legislation that the

Treasury is preparing under the relevant provisions of the Bill, and which the Treasury will seek to make available to Parliament by Committee stage in the House of Commons.

## **Retail and SME lending**

*The Commission considers that it is right in the first instance not to require banking groups with a ring-fenced entity to carry out all lending for SME and retail customers within that entity. This is a provisional conclusion, which should be subject to review in the light of experience. There is a possibility that banking groups will conduct their most profitable lending from outside the ring-fence, where capital requirements will be lower and there will be fewer restrictions on dividend payments, leaving less profitable lending within the ring-fence. This could reduce the commercial strength of the ring-fenced entity. It could also reduce the transparency of the operation of the ring-fence. The Commission recommended earlier that the regulator should monitor and publish a statement on how the ring-fencing rules have been implemented by the industry, with specific consideration being given to which services are provided inside and outside the ring-fence. The Commission has concluded that the development of retail and SME lending outside the ring-fence is a matter for the regulator to monitor as part of its work on this statement. (Paragraph 215)*

**2.31 The Government agrees with the PCBS that the flexibility on the location of the ring-fence recommended by the ICB should be maintained,** and that banking groups should not, therefore, be required to carry out retail and SME lending from within the ring-fence. Given the economic importance of credit provision to individuals and SMEs, however, it is clearly important for the Government to monitor closely any developments in this area. The Bank of England already collects for monetary policy purposes data on deposits with and lending from banks, building societies and some other lenders within the UK. These data collections could be adapted to provide in future data on lending inside and outside the ring-fence. In addition, the Government is currently working with the banking industry to secure a voluntary commitment to publish granular data on bank lending by postcode, giving greater transparency over the provision of credit. If, however, a satisfactory industry-led solution cannot be achieved, the Government will bring forward amendments to the Banking Reform Bill to ensure that granular lending data is published. The availability of these various sources of data on bank lending make a separate data-gathering exercise by the regulator unnecessary at this time.

## **Geographical restrictions**

*The Commission is broadly content with the Government's approach to meeting the ICB's objective of effective geographic limits on the business of ring-fenced banks. In pursuing this primary consideration, however, consideration needs to be given to the effects of the solution devised on UK banks' ability to support trade. It is essential that full consideration is given to the repercussions of the measures proposed. For this reason, the Commission recommends that the Treasury undertakes a full separate consultation exercise on the draft secondary legislation to give effect to geographical restrictions and publish its findings two weeks prior to the House of Commons report stage. The Commission also considers it essential that, when the relevant secondary legislation comes into force, the Treasury monitors and reports to Parliament on its assessment of the trade-off between the direct intended effects of the limits and the capacity of the banks to support trade. (Paragraph 209)*

**2.32 The Government welcomes the PCBS's endorsement of the Government's approach to the geographical scope of the ring-fence,** and agrees with the PCBS that the ring-fence should insulate UK retail banks against global financial shocks without unduly restricting banks' ability to support UK trade and inward investment into the UK. It was in order to minimise any adverse

consequences for trade and inward investment that the Government adjusted the ICB's original recommendations and adopted the current approach. As a matter of course, therefore, the Government will continually monitor the impact of the ring-fence on trade and investment once it has come into effect. Geographical restrictions will be established by secondary legislation: the Government will make available principal secondary legislation in time for the Bill's Commons Committee stage, and in line with the Government's better regulation practice proposes to publish all secondary legislation for consultation where possible.

### **Non-core deposits**

*The exemption for large deposits makes sense. It is right that holders of large deposits should be required to make an informed decision to hold their deposits in a non-retail bank. (Paragraph 203)*

**2.33 The Government agrees with the PCBS that high-net-worth private banking customers and larger organisations should be permitted (but not required) to deposit outside the ring-fence,** subject to safeguards and provided that they make an informed choice. The conditions under which such depositors may deposit outside the ring-fence will be set out in secondary legislation, which will set monetary thresholds, and require that eligible individuals and organisations must actively seek the exemption if they wish to use it.

### **De minimis exemption**

*A de minimis exemption from ring-fencing for smaller deposit-taking institutions represents a sensible compromise between maintaining financial stability and encouraging new entrants to the banking industry. Although the level of the threshold is ultimately a matter of judgement, the Commission recommends that the considerations to be taken into account by the Chancellor of the Exchequer and his successors in setting or varying the de minimis exemption should appear on the face of the Bill. In addition to the factors that we have recommended in relation to the general power under proposed section 142A(2)(b) in paragraph 135, there should be a specific requirement for a decision imposing or revising a de minimis requirement to have regard to its effect on competition in retail banking and on new entrants in the market in particular. The Commission also recommends that the regulator be required to report annually to Parliament on developments affecting the appropriateness of the level of the de minimis requirement. (Paragraph 200)*

**2.34 The Government welcomes the PCBS's agreement with the principle of a de minimis exemption from ring-fencing.** It is important that the criteria for judging the appropriate level for the exemption are clearly specified. The Government believes that the Bill already achieves this clarity, by providing that institutions may only be exempted from ring-fencing if their exemption would not be likely to have an adverse effect on the continuity of core services in the UK. In setting the de minimis level, the impact on competition would naturally always be an important consideration for the Government. For the sake of greater clarity, however, the Government will amend the Bill to include an additional requirement to have regard to the impact of the de minimis on competition. As discussed at paragraph 2.24 above, Government will also legislate for an annual review by the PRA of the workings of the ring-fence. In setting the de minimis exemption, it would always be natural for the Government to consult the regulator on the impact of different potential thresholds.

### **Additional structural separation: Volcker rule**

*The ICB's proposals should be the starting point for proposals for legislation for implementation of structural separation. However, that does not mean that they should*

*be the final destination. The current proposals may not be sufficient. In addition to concerns about proprietary trading, the case that a ring-fence will in practice be able to achieve the necessary level of separation remains unproven. The ring-fence may also be tested and eroded over time. The Commission considers it essential that steps are taken to reinforce the ring-fence, and makes specific recommendations to this effect in chapter 9. (Paragraph 94)*

*There is evidence to suggest that proprietary trading, which under the current proposals could still take place within the non-ring-fenced part of banking groups, is an activity which is incompatible with maintaining the required integrity of customer-facing banking and which could have harmful cultural effects if permitted to continue. This was the primary concern of Paul Volcker in suggesting the prohibition of such activity in US banks. (Paragraph 95)*

*The Commission has not considered fully the ramifications and practical issues of supplementing the proposed UK ring-fence with something akin to the Volcker rule. The Commission intends to take further evidence on this in the New Year. The Bill which the Government will shortly introduce provides the appropriate vehicle for establishing the future structural form of the UK banking industry. (Paragraph 96)*

*The Commission will consider further the implications of introducing a prohibition on groups containing a ring-fenced bank from engaging in proprietary trading and, in particular, the contribution such a prohibition could make to the changes needed to banking culture and standards. The Commission expects to report in good time in order that legislative effect to any recommendations can be given as the Bill progresses. (Paragraph 97)*

*Measures to tighten the regulation of UK banks beyond international norms should be assessed for their potential to cause an unwelcome shift of activity abroad. However, concerns about relocation of banks may be over-stated. They should not be allowed to dominate the decision on the measures necessary to remove the implicit guarantee and ensure the banking system serves the UK economy. We will address this in our final Report. (Paragraph 98)*

**2.35** The Government is proceeding with legislating to implement the ring-fence, as recommended by the ICB. On the question of whether to impose additional structural separation, for example a 'Volcker rule', as well as the ring-fence, the Government will consider carefully any further recommendations from the PCBS on this topic. However, the Government would need to take account of the significant difficulties in defining proprietary trading as distinct from market-making highlighted by the ICB and by the EU High Level Expert Group chaired by Erkki Liikanen, the technical challenges encountered in the course of the US implementation of the 'Volcker rule', and the risks noted by Sir John Vickers that the complexity of an additional ban on proprietary trading could, by distracting regulatory focus, prove detrimental to the ring-fence.

## **Loss-absorbency**

**2.36** The PCBS made a series of recommendations relating to loss-absorbency requirements, and specifically on:

- Leverage ratios;
- Bail-in;
- Primary Loss-Absorbing Capacity (PLAC) requirements; and
- Depositor preference.

## Leverage ratios

*Reliance on capital requirements based on risk weighted assets alone is not sufficient. The leverage ratio is an important part of banks' minimum capital requirements. If a 3 per cent leverage ratio is a backstop when the requirement in terms of RWAs is 8.5 per cent, raising the leverage ratio broadly in line with a higher requirement in terms of RWAs is logical. The Commission is not convinced about the appropriateness of the Government's decision to reject the ICB's recommendation to limit leverage at 25 times rather than 33 times. We believe that high leverage was a significant contributor to the crisis. The Commission considers it essential that the ring-fence should be supported by a higher leverage ratio, and would expect the leverage ratio to be set substantially higher than the 3 per cent minimum required under Basel III. Not to do so would reduce the effectiveness of the leverage ratio as a counter-weight to the weaknesses of risk weighting. (Paragraph 294)*

*Determining the leverage ratio is a complex and technical decision, and one which is ultimately best made by the regulator. The FPC cannot be expected to work with one hand tied behind its back. The FPC should be given the duty of setting the leverage ratio from Spring 2013. An early change to the leverage ratio would pose particular problems for some building societies. In view of their special characteristics, the regulator should carefully consider the case for longer transition arrangements for them. Changes to leverage ratios might be mitigated by changes to the tax treatment of debt and equity for banks, a matter to which we will return in our Report in the New Year. We took little evidence on the effects on regulatory arbitrage and passporting held to be a possible consequence of setting higher capital or leverage ratio at a national level than are required under Basel III. We will consider this as part of our wider work on regulatory arbitrage issues in our final Report. (Paragraph 295)*

*Simple leverage ratios have the drawback that they incentivise banks to hold the highest-yielding and therefore presumably riskiest assets that they can, and to offload as many lower-yielding and safer assets as they can into other companies. Risk-weighting of assets was introduced as a remedy. Risk-weighting has, however, been unsatisfactory and arguably dangerous in practice. Banks were allowed to set their own risk weights using their own models. Some of the weights were much too low. The zero or low weights attached to government securities have encouraged banks to acquire large amounts of what were in some cases very risky assets. Many governments have an incentive not to address this, because of their need to fund large deficits. Parliament needs to be assured that the work to improve risk-weighting is being given the highest priority. The Commission recommends that the new Bill require the Bank of England to provide an annual assessment to be laid before Parliament of progress of risk-weighting and that the assessment should examine in particular the possible operation of floors for risk-weights, and steps taken with regard to simplification of risk-weights and trading exposures. If a more independent and more skilled Supervisory Board of the Bank of England is established in accordance with the recommendations of the Treasury Committee, it would be important for this Board to provide regular oversight of the work by the Bank of England in this area. (Paragraph 296)*

**2.37** The Government strongly supports the introduction of a minimum leverage ratio as a backstop to risk-weighted capital requirements, as recommended in the Basel III Accord. The Government continues to press for full implementation of Basel III through European legislation. As the PCBS has recognised, a leverage ratio that is the primary capital constraint on banks, rather than a backstop to risk-weighted capital requirements, can create perverse incentives for low-risk banks to increase their overall level of risk. In the UK, this could particularly apply to

institutions that performed relatively well in the recent crisis. The Government does not, therefore, see the case for permanently raising the leverage ratio beyond the Basel III standard.

**2.38** The Government continues to support the inclusion of a backstop leverage ratio in the EU prudential toolkit and has committed to provide the Bank of England Financial Policy Committee (FPC) with a time-varying leverage ratio direction-making tool, but no earlier than 2018 and subject to a review in 2017 to assess progress on international standards. This is to ensure that the UK leverage ratio is consistent with international norms, which are still under development. In the interim, the FPC will be able to address systemic risks stemming from unsustainable levels of leverage or inaccurate risk-weights using the other means at its disposal, such as recommendations or by adjusting sectoral capital requirements.

**2.39** The Government agrees with the PCBS that during the recent crisis the risk weights ascribed to some bank assets proved to be a poor reflection of those assets' actual riskiness. In response to this the Capital Requirements Directive (CRD) 3 (which was implemented in 2011) significantly increased the risk weights on some of the riskiest assets, such as complex securitisations. Building on this, it is clearly important that risk-weights be made as robust as possible, and the Government also notes ongoing work by bodies such as the Basel Committee on Banking Supervision (BCBS) and the European Banking Authority (EBA) to review risk-weights internationally. With these reviews under way, the Government believes an additional UK-specific assessment of risk-weights to be unnecessary.

## **Bail-in**

*An effective and credible bail-in tool would represent a major step towards eliminating the implicit guarantee and ensuring that the costs of resolving a failing bank are not borne by the taxpayer. It is notable that bail-in is at the heart of the resolution strategies currently being designed for large systemically important banks, and will remain important even after the ring-fence is introduced. (Paragraph 236)*

*Concerns remain about the design of a bail-in regime and whether it will provide confidence that the authorities would actually use their powers in the event of a crisis. The new tool risks being of particularly limited utility if the authorities were required to impose losses beyond the holders of specifically "bail-inable" debt and move up the chain to, say, corporate depositors. The legal and economic implications of bailing in a bank's creditors will never be known until it is tried for the first time under stressed conditions, and politicians and regulators will always face pressure to incur the better-understood costs of a taxpayer bailout instead. It should be a requirement that bail-inable debt is held outside the banking system, to reduce contagion risks within the banking system. The regulator should make early proposals on how best to accomplish this. Uncertainty about the size and nature of market for loss-absorbing debt will also mean that doubts will remain over whether bail-in will function as intended and what its costs will be. Parliament will need assurance that bail-in is not a paper tiger, as will the markets. The Commission recommends accordingly that the Bank of England be subject to a statutory requirement under the new legislation to produce an annual report to Parliament on the development and subsequent operation of bail-in to assist in assessment of its feasibility, which should be required to cover in particular:*

- *The quantity of issued debt with characteristics which make it easily subject to bail in;*
- *Whether bail-inable debt is being issued out of the correct corporate entity within a banking group to facilitate the preferred bail-in strategy;*
- *The distribution of holdings of bail-inable bank debt within the rest of the financial system;*

- *The feasibility of mechanisms for bailing in creditors other than long-term unsecured bonds, such as corporate depositors, uninsured household depositors and derivative counterparties;*
- *Progress towards addressing international legal barriers to the recognition of bail-in actions. (Paragraph 242)*

*The Commission supports the Government's endeavours to implement a bail-in regime in the UK. The Government should also continue to negotiate for a broad bail-in power to be applied across the EU. Bail-in is an important tool for resolving bank failures in a way that prevents the huge costs. The Commission is concerned at the risk that the development of such a tool might be delayed or watered down through negotiations at EU level and, given the size of the financial services sector relative to the UK economy, the Commission believes the Government should act at a UK level in the event of EU discussions not resulting in the desired protection for the taxpayer that bail-in aims to ensure. The Commission recommends that the Government make provision in the forthcoming legislation for bail-in powers at national level which could come into force if the EU proposals were delayed or inadequate, on the understanding that negotiations at European level would need to secure the subsequent removal of any existing or prospective European legal obstacles to the use of a more wider-ranging power at national level. (Paragraph 245)*

**2.40** The Government agrees with the PCBS that an effective and credible bail-in power is an essential element of the resolution 'toolkit' required to manage the orderly failure of systemically important cross-border banks. This can be best achieved by working with other countries to design and implement a bail-in regime that is recognised in and can work across different jurisdictions, to ensure better international co-operation in a crisis scenario, to reduce opportunities for geographical arbitrage, and to minimise the risk of UK banks being at a competitive disadvantage relative to international competitors.

**2.41** The Government remains confident that the UK will implement bail-in through transposition of the EU RRD, and welcomes the recent European Council conclusions "[urging] the co-legislators to agree on the proposals for a Recovery and Resolution Directive...before June 2013...Once adopted, these Directives should be implemented by the Member States as a matter of priority."<sup>3</sup> The Government, in partnership with the Bank of England and the regulator, will continue to work closely with European partners and the European Commission on the design of the bail-in tool, to ensure that it enables authorities to impose losses on banks' creditors rather than taxpayers.

**2.42** The Government agrees that it would be appropriate for Parliament to have assurance that the bail-in regime to be implemented in the UK and across Europe is effective and credible. The FSB are to conduct peer reviews of implementation of the *Key Attributes*, which have been endorsed by the G20, to assess and report on whether the full set of agreed resolution powers and tools, including bail-in, are being appropriately implemented in the UK and in other countries.

### **Primary loss-absorbing capacity (PLAC) requirements**

*Exemptions from PLAC increase the risk that, in a crisis, the UK would need to intervene in respect of overseas operations of a UK-based bank, but would lack the level of PLAC necessary to shield the taxpayer. The Commission recommends that the secondary legislation to be made under to section 142J of the draft Bill place the burden of proof for*

---

<sup>3</sup> European Council Conclusions, 13/14 December 2012, [http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ec/134353.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/134353.pdf).

any exemption from PLAC requirements on the bank seeking the exemption, rather than on the regulator. This would mean that the regulator would only grant an exemption if a bank had demonstrated to the regulator's satisfaction that there was no risk to stability, rather than merely if the regulator could not show that a risk existed, providing a greater level of protection to the taxpayer. This should include the bank showing that the resolution authorities in the areas in which they operate outside the EEA would assume lead responsibility for resolving the operations in those overseas territories in the event of the bank's failure, in order to protect the UK taxpayer. The decision on whether to grant an exemption should be made by the regulator with reference to clear objectives, although in all cases it will need to involve an exercise of judgment by the regulator. Decisions should be subject to the same review and appeals processes as any other decision by the regulator. The existence of exemptions should be publicly disclosed. It will also be important for the regulator to monitor the implications of exemptions in the case of each firm affected on an ongoing basis. We would expect this monitoring to be the subject of regular review by a strengthened Supervisory Board of the Bank of England introduced in accordance with the recommendations of the Treasury Committee. (Paragraph 258)

The broad, largely unconstrained powers contained in proposed section 142J of FSMA could be used by the Treasury to set a framework which removes the regulator's discretion over whether to grant a PLAC exemption. There is also a possibility that the Treasury could use the power to intervene in individual decisions on exemptions from PLAC requirements. If this was used to overrule the regulator's decision on individual cases, this would be a highly inappropriate political intervention. (Paragraph 262)

The Commission accepts that the Treasury should have certain powers to implement the PLAC requirements, and that secondary legislation is the appropriate vehicle: primary legislation is not appropriate for such technical matters, and the changes will in some cases be too important to be left solely to the discretion of the regulator. However, as drafted, these powers are extremely wide-ranging, are subject only to the negative resolution procedure, and need not be deployed with reference to any particular policy objectives. Furthermore, an order made under these provisions may confer a general power to give further directions to the regulator without further parliamentary oversight. This places an unacceptable level of unconstrained power in the hands of the Treasury. The Commission recommends that:

- the Bill require the powers of direction the Government acquires under proposed section 142J to be exercised with reference to policy objectives stated on the face of the statutory instrument which grants those powers;
- the order-making powers under proposed section 142J be subject to the affirmative resolution procedure, rather than the negative resolution procedure, to ensure a greater degree of parliamentary oversight; and
- the power under proposed section 142J(4)(d) to "confer power on the Treasury to issue directions to the regulator as to specified matters" be removed from the draft Bill altogether.

The Commission also notes that the remaining powers of the Treasury to direct the regulator in relation to the implementation of the PLAC requirements will need very careful monitoring. (Paragraph 263)

**2.43** The Government welcomes the PCBS's recognition that the Treasury should have a role in shaping how the regulator applies PLAC requirements, as such decisions will be inextricably

bound with Treasury objectives to manage and protect public finances and to support long-term and sustainable economic growth. The Treasury remains accountable to Parliament for delivering these objectives, which would be the reference point for exercising powers the Government proposes to acquire under section 142M (previously section 142J).

**2.44** The Government believes that where the overseas operations of a UK-headquartered globally systemically important bank pose no threat to UK, and European, financial stability, that bank should not be required to hold PLAC at group level against those operations. As the Chancellor argued in his evidence to the PCBS, such a requirement would risk creating an erroneous perception that the UK was responsible for the supervision of those overseas operations, or that UK public support might be extended to them in the event of failure. The Government continues to consider the details of how this principle will be implemented, and accepts there may be merit in the PCBS's proposal to place the burden of proof for any exemption on the bank, provided that the regulator exercises its judgement in a reasonable way. The Government agrees with the PCBS that it is essential that any decisions on individual firms are made within a clear framework established in legislation. The details of this framework will be set out in secondary legislation to be made under the new section 142M. A draft of this statutory instrument will be provided for the information of Parliament.

**2.45** On the delegated powers under section 142M, as noted at paragraph 2.18 above, the Government has amended the Bill so that this power is subject to the affirmative resolution procedure, and, following the PCBS's recommendation, the broad power of direction previously in section 142J(4)(d) has been revised.

### **Depositor preference**

*It is crucial that deposit insurance be designed so as to avoid creating irresistible political pressure for ad hoc extension in the event of bank failure, as was the case in the last crisis. Implementation of the proposal for preference for insured deposits, by increasing prospective losses for others, has the potential to accentuate such pressure. Depositor preference would also appear to be in conflict with one of the resolution strategies favoured by the Bank of England, involving bail-in of the deposit insurance scheme. Both the above points weaken the credibility of the Government's proposal. The Commission considers that the Treasury's case that all non-insured creditors, including charities and small businesses and temporary high deposits of households, would be treated alike in the event of failure, is unconvincing. In view of these problems, the Commission recommends that the Government and Bank of England establish a joint group to prepare and publish a full report on the implications for resolution of depositor preference and of the scope and extent of depositor insurance. This report should, in particular, consider the feasibility of establishing a voluntary scheme of insurance for deposits over £85,000 with arrangements for opt-out. This report should be published at least two weeks before the House of Commons report stage of the Bill. (Paragraph 279)*

**2.46** The Government is implementing the ICB's recommendation to introduce preference for deposits protected by the Financial Services Compensation Scheme (FSCS) ('insured deposits').<sup>4</sup> It recognises there is merit in having the FSCS contribute to resolution costs. However, as the taxpayer ultimately stands behind the FSCS where the wider industry cannot foot the bill, it is important to protect the FSCS by ensuring that it can claim in an insolvency ahead of other creditors of a failed bank: insured depositor preference achieves this.

---

<sup>4</sup> Subject to it successfully negotiating the necessary provisions in the European Recovery and Resolution Directive.

**2.47** Extending this preference further to other uninsured depositors will reduce this protection, while also discouraging people and organisations from managing their risk. And preferring everyone risks protecting no-one. The scope and operation of FSCS coverage cannot currently be extended beyond the limits set by EU law in the Deposit Guarantee Scheme Directive (DGSD).

**2.48** Negotiations are still ongoing in the European institutions on a revised version of the DGSD aimed at improving depositor protection across the EU. This includes proposals that would extend FSCS coverage to businesses and many other organisations regardless of size, and allow Member States to provide coverage above the harmonised coverage level of £85,000 for certain temporary high balances. Extending FSCS protection in this way should reduce pressure for any government support beyond the scope of the FSCS. The Government recognises the importance of examining the exceptional circumstances where FSCS coverage could be extended, and proposes to consider this issue further once the Directive is finalised and due to be implemented in the UK.

## Other recommendations

**2.49** The PCBS also made two further recommendations, relating to the risk of banks using the establishment of the ring-fence to evade pre-existing liabilities; and to fees charged by the regulator to cover certain Treasury expenditures.

### Liabilities

*The Commission finds it disconcerting that the Treasury should raise the possibility that the establishment of the ring-fence might lead to the dissolution of a company and the cancellation of its liabilities. The onus should not be on the regulator to prohibit the dissolution of a company. Nor should the onus be on creditors of a company to make a court application to restore the company in order to meet obligations. The Commission recommends accordingly that the regulator be required to set rules to ensure that the creation of ring-fenced and non-ring-fenced entities is not used as an opportunity to shift liabilities or potential liabilities in an artificial way. (Paragraph 230)*

**2.50** The reference to the effect of dissolution on a company's liabilities in the Treasury's evidence was made for the sake of providing a full explanation on the law in this area, and should not be seen as a suggestion that the Treasury considers that this is a likely outcome. The Government considers that this would be most unlikely. Ring-fencing is expected to result in corporate re-organisations with the transfer of existing business from one business to another, and, in some cases the creation of new companies, but not dissolutions of a company. The regulator will have a role in this area: but simply because it will be required to approve any application to the court for an order under Part VII of FSMA to sanction a scheme for a business transfer scheme made to implement ring-fencing. The Government does not consider that any further safeguard is needed in this area.

### Fees for HM Treasury expenses

*The Commission accepts the principle that those creating the risks that need to be regulated should bear the costs of regulation, including costs of cooperating with international authorities. If provisions based on Clause 9 are included in the Bill, the Commission considers it essential that the Clause be amended to limit the levy to recovery of subscriptions rather than unspecified expenses, so that the provision cannot be used by a future Government to recover part of the Treasury's running costs, such as the salaries of civil servants involved in this work. (Paragraph 300)*

**2.51** The Government agrees with the PCBS that provisions in clause 13 (previously clause 9) should be limited to the recovery of subscriptions and membership fees related to Treasury's

participation in international organisations. The Government has therefore amended the Bill to limit the power to require the payment of fees so that fees may only be charged in respect of those expenses that represent a contribution to the resources of the international organisation. This will ensure that the scope of the power cannot be used to recover administrative costs of the Treasury.

# A

## Impact assessment

---

**A.1** The following pages contain the Government's impact assessment for the Financial Services (Banking Reform) Bill.

<b>Title:</b> Financial Services (Banking Reform) Bill <b>IA No:</b> HMT1302  <b>Lead department or agency:</b> HM Treasury  <b>Other departments or agencies:</b> Department for Business, Innovation and Skills	<b>Impact Assessment (IA)</b>		
	<b>Date:</b> 09/01/2013		
	<b>Stage:</b> Final		
	<b>Source of intervention:</b> Domestic		
	<b>Type of measure:</b> Primary legislation		
<b>Contact for enquiries:</b> Banking.commission@hmtreasury.gsi.gov.uk			
<b>Summary: Intervention and Options</b>			<b>RPC Opinion:</b> GREEN

Cost of Preferred (or more likely) Option			
Total Net Present Value	Business Net Present Value	Net cost to business per year (EANCB on 2009 prices)	In scope of One-In, Measure qualifies as One-Out?
£117,600m	£m	£m	No
			NA

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

Structural reform of UK banks is required to tackle the 'too big to fail' problem: banks that are large, systemic and too complex for their failure to be safely managed without serious economic consequences or recourse to public funds are perceived to benefit from an implicit government guarantee. This represents an anti-competitive subsidy to large banks, creates moral hazard and places a contingent liability on the taxpayer. The UK Government, along with G20 partners, has committed to removing any implicit guarantees to the banking system.

**What are the policy objectives and the intended effects?**

The policy objective is to curtail the perceived implicit government guarantee enjoyed by banks seen as 'too big to fail' and make UK banks more resilient to shocks and more resolvable in the event of failure by:

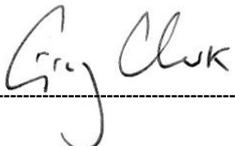
- requiring the ring-fencing of retail deposit-taking from wholesale/investment banking, to insulate essential retail banking services from shocks originating elsewhere in the financial system, and to ensure that the continuity of these services can be maintained in the event of bank failure; and
- preferring retail deposits in insolvency and setting a framework for the imposition of debt requirements by regulators, to ensure that in the event of failure losses fall on bank creditors not depositors or taxpayers.

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

The Banking Reform Bill is the latest step in a process of policy development that began with the establishment of the Independent Commission on Banking (ICB) in June 2010. The ICB examined a range of alternative structural and non-structural reform options to tackle the 'too big to fail' problem, including full separation of retail from investment banking and narrow banking. In its final report in September 2011, the ICB rejected these alternatives in favour of ring-fencing, depositor preference and other loss-absorbency reforms. The Government accepted the ICB's recommendations and has explored different options for the precise calibration of ring-fencing and depositor preference, and published a White Paper consulting on these alternatives in June 2012. Following this process, the Government has now formed its lead option, to proceed with the measures in the Banking Reform Bill. The Government believes that this option represents the best balance between benefits to financial stability and costs to UK banks and the economy.

<b>Will the policy be reviewed?</b> It will not be reviewed. <b>If applicable, set review date:</b> Month/Year					
Does implementation go beyond minimum EU requirements?			No		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	<b>Micro</b> No	<b>&lt; 20</b> No	<b>Small</b> No	<b>Medium</b> Yes	<b>Large</b> Yes
What is the CO <sub>2</sub> equivalent change in greenhouse gas emissions? (Million tonnes CO <sub>2</sub> equivalent)			<b>Traded:</b> N/A	<b>Non-traded:</b> N/A	

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

Signed by the responsible Minister:  Date: 09/01/2013

# Summary: Analysis & Evidence

# Policy Option 1

**Description:** The Government does not implement any of the measures in the Financial Services (Banking Reform) Bill. This is the baseline used for measuring the impact of Policy Option 2.

## FULL ECONOMIC ASSESSMENT

Price Base Year	PV Base Year	Time Period Years 30	Net Benefit (Present Value (PV)) (£m)		
			Low: 0	High: 0	Best Estimate: 0

COSTS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	0	0	0
High	0	0	0
Best Estimate	0	0	0

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

Zero as the Government not implementing the measures in the Banking Reform Bill will impose no additional costs incremental to regulations currently in train.

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

Zero for the reason given above.

BENEFITS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0	0	0
High	0	0	0
Best Estimate	0	0	0

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

Zero as the Government not implementing the measures in the Banking Reform Bill will produce no additional benefits incremental to regulations currently in train

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

Zero, for the reasons given above.

Key assumptions/sensitivities/risks	Discount rate (%)
-------------------------------------	-------------------

## BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:	In scope of OIOO?	Measure qualifies as
Costs: N/A	No	NA
Benefits: N/A		
Net: N/A		

# Summary: Analysis & Evidence

# Policy Option 2

**Description:** Proceed with measures in the Financial Services (Banking Reform) Bill

## FULL ECONOMIC ASSESSMENT

Price Base Year 2012	PV Base Year 2019	Time Period Years 30	Net Benefit (Present Value (PV)) (£m)		
			Low: SEE TEXT	High: SEE TEXT	Best Estimate: 117,600

COSTS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	1,500	400	7,600
High	2,500	1,120	20,900
Best Estimate	2,000	720	13,700

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

Direct private costs to UK banks: £2bn - £5bn p.a. Direct costs to regulator: £20m (up-front), £2m p.a.  
 Indirect cost to GDP from banks passing increased private costs to economy: reduction in long-run GDP level of 0.04% - 0.1% (equivalent to average annual GDP cost of £0.4bn - £1.1bn p.a.)  
 Indirect Exchequer impact: reduction in tax receipts of £150m - £400m p.a. and reduction of value of HMG shareholdings in RBS and Lloyds Banking Group of £2bn - £5bn, relative to 'do nothing' baseline.

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

Indirect cost to bank customers through changes in lending and saving rates.  
 Direct cost to large UK banks of ensuring that ring-fenced banks are not liable for the pension liabilities of other members of their banking groups.

BENEFITS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	SEE TEXT	SEE TEXT	SEE TEXT
High	SEE TEXT	SEE TEXT	SEE TEXT
Best Estimate	SEE TEXT	6,900	131,300

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

Greater financial stability leading to fewer and less severe financial crises in the future, leading to higher levels of GDP in the future. This is a benefit to the UK economy as a whole.  
 Illustrative calculation shows that reducing probability of future crises by 10% and severity of future crises by 15% would produce an annual benefit equivalent to 0.47% of GDP (£6.9bn in 2010-11 terms).

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

Reduced Government, and therefore taxpayer, support in a crisis as they become less frequent and severe. Resolution authorities will be better able to resolve banks and at a lower cost.  
 There will be welfare benefits independent of GDP level, from greater financial and economic stability due to a reduction in the probability and severity of financial crises for the UK economy.

Key assumptions/sensitivities/risks	Discount rate (%)	3.5
The reduction in the future probability and severity of financial crises that the policy will bring. The extent to which banks pass through the cost of the policy to consumers, and the subsequent impact on GDP.		

## BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: N/A	Benefits: N/A	Net: N/A	No	NA

# Evidence Base

## Introduction

1. The financial crisis of 2007-09 revealed the urgent need to reform the UK banking system to improve the resilience of both individual banks and the system as a whole. In response to the crisis, as well as embarking on the radical reform of the UK regulatory architecture through the Financial Services Act 2012, the Government has committed to implementing structural reforms to UK banks, following the recommendations of the Independent Commission on Banking (ICB), chaired by Sir John Vickers.
2. As the ICB argued, banks that are large, systemic and too complex to be resolved in the event of failure benefit from a perceived implicit government guarantee, as market participants presume that, faced with the failure of such a bank, the Government would have no choice but to rescue it, if necessary using public funds. As well as creating moral hazard, this perceived guarantee represents an anti-competitive subsidy to large, complex banks and a contingent liability on the taxpayer. Along with other G20 members, the Government has committed to curtailing perceived implicit guarantees to the UK banking sector. The Financial Services (Banking Reform) Bill ('the Bill') contains key measures to give effect to that commitment.
3. The Bill will implement the ring-fencing of retail and SME deposits from wholesale and investment banking recommended by the ICB. Ring-fencing, and the requirement that ring-fenced banks be separately capitalised and economically independent of their wider corporate groups, will insulate retail banking services from shocks originating elsewhere in the global financial system and will make both individual banks and the UK banking system as a whole more resilient. By requiring that retail banking services whose continuous provision is essential to households and SMEs are placed in separate legal entities, ring-fencing will help ensure that the continuity of those services can be maintained in the event that a ring-fenced bank, or its wider group, fails and needs to be resolved by the authorities.
4. The Bill will also make deposits eligible for protection under the Financial Services Compensation Scheme (FSCS) preferred debts in insolvency: preferring FSCS-protected deposits will help the authorities to ensure that in the event of failure, banks' wholesale creditors will be exposed to losses ahead of retail depositors and the FSCS that protects them. These creditors will now have a greater incentive to curb excessive risk taking by banks. Some elements of the ICB's recommendations are not included in the Bill, for example the introduction of a bail-in tool, which the Government expects to deliver through transposition of forthcoming European legislation. These measures are therefore outside the scope of this Impact Assessment (IA).
5. The measures in the Bill will serve to curtail the perceived implicit government guarantee to banks seen as 'too big to fail'. The Bill is the latest stage of a process of policy development to meet this objective that began with the establishment of the ICB in the summer of 2010. Over the course of its deliberations, the ICB considered, and rejected, a range of alternative policy options, including full separation of retail and investment banking, full reserve banking and narrow banking, before forming its recommendations on ring-fencing and loss absorbency. The Government has accepted those recommendations, and since the ICB's final report in September 2011 has explored a range of possible calibrations for ring-fencing and depositor preference. Having examined these alternatives, the Government has now developed its lead option, which will be implemented via the Bill. This IA sets out the estimated economic impact of the measures in the Bill.

# Scope of this IA

## *Measures included in this IA*

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

## *Measures not included in this IA*

### ICB recommendations not included in the Banking Reform Bill

7. The Bill will implement key elements of the ICB's recommendations, as set out above. However, some of the ICB's recommendations have been accepted by the Government but are being implemented by other means (including by other domestic or EU legislation), and so are not included in the Bill. As they do not feature in the Bill, the impact of these measures is not included in this IA:
- A **bail-in tool**: the Government expects bail-in to be implemented in the UK through transposition of the EU Recovery and Resolution Directive (RRD). The Government continues to work closely with EU partners to ensure that a credible and consistent bail-in tool is delivered.
  - **ICB competition recommendations**: the ICB made various recommendations to increase competition in the banking sector. The recommendations have been accepted by the Government, but are not included in the Bill (and so are not covered in this IA) as they are either already implemented (Financial Conduct Authority competition objective); industry-led (Lloyds Banking Group 'Verde' divestment; account switching service); or will not result in immediate regulatory changes (possible future market investigation by competition authorities).
8. As a result of the exclusion of these measures from this IA, the figures given here for the total impact of the measures in the Bill will not be the same as those for the total cost of the entire ICB package given in the Banking Reform White Paper IA. This is because the White Paper IA included the impact of measures that are not covered by this IA.<sup>1</sup>

### Non-ICB policy measures in the Banking Reform Bill

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

---

<sup>1</sup> The White Paper IA estimated the total private cost to UK banks of the whole ICB package as falling in the range £4bn-£7bn per year and the GDP cost in the range £0.6bn-£1.4bn per year. The electronic version of the Banking Reform White Paper and accompanying IA can be found at [http://www.hm-treasury.gov.uk/fin\\_stability\\_regreform\\_icb.htm](http://www.hm-treasury.gov.uk/fin_stability_regreform_icb.htm).

# Description of options considered

## *Option 1: Baseline (“Do nothing”)*

11. It is important to isolate the incremental impact of the measures in the Bill from that of other regulatory changes related to financial services that are proceeding independently of the Bill. The Government has therefore constructed for this IA a ‘do nothing’ option in which none of the measures in the Bill are implemented, but in which wider regulatory changes go ahead, including:

- Implementation of the Basel III Accord (through the EU Capital Requirements Directive (CRD) IV/ Capital Requirements Regulation (CRR)), including higher capital requirements for banks and tighter definitions of capital;
- Introduction of a Globally Systemically Important Banks (G-SIB) capital surcharge to impose additional capital requirements on the largest and most systemically important banks;
- Liquidity requirements imposed by the Financial Services Authority (FSA); and
- Reform of the UK regulatory architecture through the Financial Services Act.<sup>2</sup>

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

## *Option 2: Implement the measures in the Banking Reform Bill*

13. The Government’s lead option is to proceed with the measures in the Banking Reform Bill. These are:

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

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

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

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

---

<sup>2</sup> More details on these regulatory reforms can be found at the following links:  
[Basel III Capital Requirements, Globally Systemically Important Banks \(G-SIB\) Surcharge and Counter-Cyclical Buffer](http://www.bis.org/publ/bcbs189.pdf) - <http://www.bis.org/publ/bcbs189.pdf> and <http://www.bis.org/publ/bcbs207.pdf>.  
[FSA Liquidity Regulations](http://www.fsa.gov.uk/pages/library/policy/policy/2009/09_16.shtml) - [http://www.fsa.gov.uk/pages/library/policy/policy/2009/09\\_16.shtml](http://www.fsa.gov.uk/pages/library/policy/policy/2009/09_16.shtml).  
[FPC Macroprudential Powers](http://www.bankofengland.co.uk/financialstability/Pages/fpc/default.aspx) – <http://www.bankofengland.co.uk/financialstability/Pages/fpc/default.aspx>.  
[The Financial Services Act](http://www.hm-treasury.gov.uk/fin_financial_services_bill.htm) – [http://www.hm-treasury.gov.uk/fin\\_financial\\_services\\_bill.htm](http://www.hm-treasury.gov.uk/fin_financial_services_bill.htm).

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

- **Preferring deposits** eligible for protection under the FSCS (**'depositor preference'**): The Bill will provide that all deposits which are eligible for compensation under the FSCS ('insured deposits') are preferential debts, so that, in the event of the insolvency of a bank, they will rank ahead of the claims of other unsecured creditors. Since the FSCS will take on the claims of insured depositors, the effect will be to increase the amount which the FSCS is able to recover in the event of bank failure, reducing the amount required from surviving banks and consequently limiting the threat of contagion or contingent taxpayer liability.
- Setting the **framework for the imposition of debt requirements** by the regulator on banks. The Bill gives the Treasury a power to make an order regulating the way in which the regulator may exercise its powers under the Financial Services and Market Act 2000 to impose debt requirements on banks (including ring-fenced banks). The Government considers that it will be possible to use this power to implement loss absorbency requirements in line with the ICB's recommendations.  
  
Banks should be required to hold sufficient loss-absorbing capacity to ensure that they are more resilient against failure and that, if they do fail, losses can be borne by their shareholders and uninsured unsecured creditors rather than falling on the taxpayer.

### Enabling nature of the Banking Reform Bill

14. The Bill will largely be enabling in nature: it will give powers and/or duties to HM Treasury and the regulatory authorities to impose requirements on UK banks. The precise nature of those requirements will be determined by a combination of secondary legislation and rules made by the regulators. These will define the details of, for example, what activities may not be conducted within the ring-fence, and the financial relationships between ring-fenced and non-ring-fenced banks. The exact impact of the Banking Reform Bill will therefore depend on how these powers and duties are discharged.
15. For the purposes of this IA, assumptions have been made about the precise requirements that will be imposed by secondary legislation and/or regulatory rules. These are detailed in Annex A below. It has generally been assumed that secondary legislation and rules made under the powers conferred by the Bill will be in line with the policy set out in the June Banking Reform White Paper and in the Policy Document published alongside the draft Bill.<sup>4</sup>
16. When, following the passage of the Banking Reform Bill, secondary legislation is made it will be accompanied by further IAs covering the contents of that secondary legislation. The regulators are also required to publish rules in draft, with accompanying cost-benefit analysis.

---

<sup>4</sup> Exceptions are when banks were not able to model the impacts based on these policy assumptions, but had to use their own assumptions instead. This is not expected to make a significant difference to the total impact: see paragraphs 38-39 below.

## Costs and benefits

### Summary of the costs and benefits of each policy option

Option 1: Do nothing (Baseline)
The baseline policy option has <b>zero</b> incremental costs and benefits.
Option 2: Implement measures in Banking Reform Bill
<b><u>Monetised costs (gross):</u></b> Annual total private cost to UK banks: £2bn – £5bn; <u>Reduction in long-run GDP level: 0.04% – 0.1%;</u> (equivalent to average annual GDP cost of £0.4bn – £1.1bn); <b>Present Value GDP cost:</b> £7bn – £20bn; Reduction in annual tax receipts: £150m – £400m; Reduction in value Government shareholdings in Royal Bank of Scotland (RBS) and Lloyds Banking Group: £2bn - £5bn. <b><u>Monetised benefits (gross):</u></b> <u>Illustrative increase in long-run GDP level from greater financial stability: 0.47%;</u> (equivalent to annual GDP increase of £6.9bn in 2010-11 terms); <b>Illustrative Present Value GDP benefit:</b> £131.3bn. <b><u>Non-monetised benefits:</u></b> Improved resilience and resolvability of UK banks will, by curtailing perceived implicit government guarantees, reduce moral hazard and thus incentives for banks to take excessive risks. Greater financial stability will support greater economic stability. Curtailing the perceived implicit government guarantee will reduce the Government's contingent liabilities to the banking sector, supporting lower Government borrowing costs.

17. All estimates in the table above are incremental to the 'Do nothing' baseline option described in paragraphs 11-12 above (which has zero costs and benefits relative to itself). The sections below discuss the costs and benefits of proceeding with the Bill measures.

### Costs of option 2: Proceed with Banking Reform Bill

18. The Government's estimates of the costs of implementing the ring-fencing and depositor preference measures in the Banking Reform Bill, are set out in the following sections:

- Overview: how costs arise;
- Private cost to UK banks;
- Social cost (cost to GDP); and
- Cost to the Exchequer.

#### ***Overview: how costs arise***

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

## *Private cost to UK banks*

### Curtailment of the perceived implicit government guarantee

20. The principal economic cost to UK banks of implementing the measures in the Bill will arise from the curtailment of the perceived implicit government guarantee enjoyed by banks seen as 'too big to fail'. To the extent that investors believe that the Government would not be willing to see a bank fail, that bank enjoys a perceived implicit guarantee, which acts to lower the bank's cost of funding as well as the level of capital that the market would require it to hold. Academic estimates of the value of this perceived implicit guarantee range from £6bn to £100bn per annum.<sup>5</sup>
21. Some progress has been made in curtailing the perceived implicit guarantee; it can be argued that the implementation of the Special Resolution Regime (SRR)<sup>6</sup> has already sent a strong signal to the market that banks cannot expect to benefit from taxpayer-funded bail-outs to the same degree as previously. But there is no consensus on the extent to which this has already been priced in by the market. Implementation of the measures in the Banking Reform Bill will curtail the perceived implicit government guarantee, by making banks more resilient and resolvable.

### Operational cost of structural separation

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

### *Total cost to GDP (social cost)*

23. In the first instance, an increase in banks' costs will have little or no impact on GDP as these costs to banks create benefits to other agents in the UK economy. For example, a rise in the cost of wholesale funding will represent an increase in a cost to banks, but also an increase in income to bank creditors. If there were no change in behaviour from this re-pricing of bank wholesale funding, there would be no change in GDP.
24. The impact on GDP materialises as banks, individuals and businesses change their behaviour in response to this transfer of costs. Faced with higher private costs, banks may pass through costs on to customers by increasing the price of credit they extend to individuals and businesses. This would act to increase the cost of servicing debt for households and the cost of capital for business, impacting household consumption and business investment, and hence GDP. Alternatively, banks may pass a portion of the cost onto shareholders (in lower returns) or employees (in lower pay). This could have an impact on GDP should the change in shareholder or employee income lead to a change in their consumption and investment behaviour.
25. The social cost is the most important cost for the purposes of the Government's cost/benefit analysis. This is because the benefits of greater financial stability (the objective of the policy) will be to the economy as a whole. For a discussion of the benefits of the measures in the Banking Reform Bill, see paragraphs 80-92 below. The appropriate comparison for cost/benefit analysis is therefore between the GDP cost and the GDP benefit of the Bill measures.

### *Cost to the Exchequer*

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

---

<sup>5</sup> 'The Implicit Subsidy to Banks', Financial Stability Paper 15, Bank of England, May 2012.

<sup>6</sup> For more details on the SRR see: [http://www.bankofengland.co.uk/financialstability/Pages/role/risk\\_reduction/srr/default.aspx](http://www.bankofengland.co.uk/financialstability/Pages/role/risk_reduction/srr/default.aspx).

27. The impact on tax receipts flows from the cost to GDP. In the long run, the principal determinant of tax receipts is GDP, so all else being equal a lower level of GDP will result in lower annual tax receipts for the Exchequer. Higher private costs to banks that are partially publicly owned (such as RBS and Lloyds Banking Group) could also impact on their share prices, and thus the value of the Government's shareholdings.

### *Gross costs*

28. It is important to note that the costs described here are gross costs, i.e. they take no account of the benefits to society, GDP or the Exchequer of greater financial stability as a result of implementing the measures in the Banking Reform Bill. The benefits of the policy option are discussed in paragraphs 80-92 below.

### *Private cost to UK banks*

#### *Summary of private cost to UK banks*

29. The Government estimates that the total private cost to UK banks of the ring-fencing and depositor preference measures in the Bill will be in the range **£2bn - £5bn per year**, with one-off transitional costs in the range £1.5bn-£2.5bn. Establishing a framework for the imposition of debt requirements by the regulator, will not in itself, create any additional costs to UK banks.

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

- Ring-fencing;
- Depositor preference; and
- Framework for imposition of debt requirements by the regulator.

### *Ring-fencing*

#### *Summary of private cost*

31. The Government estimates that the aggregate private cost of ring-fencing to UK banks will be in the range £1.7bn-£4.4bn per year, with one-off transitional costs in the range £1.5bn-£2.5bn.

#### *Modelling the cost to UK banks of ring-fencing*

32. The costs to banks of ring-fencing have been modelled in four components:

- **Capital Costs:** to meet separate capital requirements for ring-fenced and non-ring-fenced banks, banking groups may need to hold more capital in aggregate than in the baseline scenario, generating an ongoing cost.
- **Funding Costs:** following ring-fencing, the ongoing cost of wholesale funding for non-ring-fenced banks may rise, as deposits are separated into the ring-fence and if investors perceive non-ring-fenced banks as riskier and more volatile. Conversely, however, the funding cost of ring-fenced banks may fall, if investors see them as better capitalised and less volatile. There may also be a quantity effect on banks' funding requirements as higher levels of capital displace some wholesale debt on the liabilities side of their balance sheets.
- **Operational Costs:** banks may incur additional ongoing operating costs from ring-fencing, for example through needing to operate separate administrative systems for ring-fenced and non-ring-fenced entities.
- **Transitional Costs:** restructuring in order to meet ring-fencing requirements may involve one-off costs in creating new legal entities and administrative structure, transferring business units, etc.

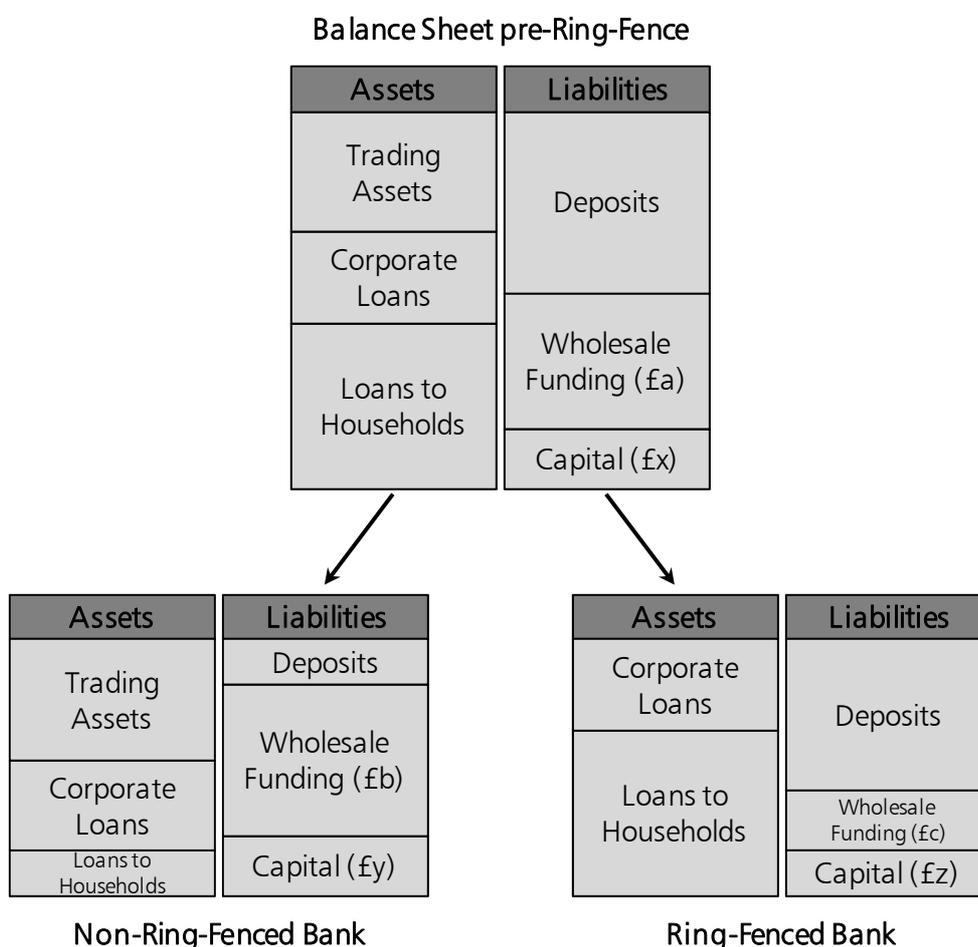
33. The **capital and funding costs** of ring-fencing were estimated by drawing on the results of extensive scenario modelling commissioned from the major affected UK banks, simulating the effects of ring-fencing. The banks were asked to model their future balance sheets first under the regulatory conditions set out for

the baseline scenario (Option 1), and then in a scenario in which ring-fencing was in force (according to the regulatory assumptions described in paragraphs 42-45 below). To reflect the flexible nature of the ring-fence, banks were left free to decide whether permitted activities (for example household and corporate lending, large corporate deposits) were to be placed in their ring-fenced or non-ring-fenced entities, according to their own preferred commercial strategies.

34. On the basis of this scenario modelling, the Government calculated the aggregate additional capital required by all the affected banks: multiplying this by an assumed range for the cost of capital gave the incremental annual capital cost. The banks' balance sheet scenario modelling also gave the change in the quantity of wholesale funding required by the different banks relative to the baseline. Applying assumptions for the impact of ring-fencing on the cost of funding for ring-fenced and non-ring-fenced banks gave the incremental annual funding cost of ring-fencing. See Box 1 below for further details on how the Government calculated the capital and funding costs.

*Box 1: An illustration of the method for calculating the capital and funding costs*

The Government asked the major affected banks to model their future balance sheets, first under a 'baseline' scenario, and then after a separation into ring-fenced and non-ring-fenced banks. This separation of assets and liabilities can be represented in the schematic diagram below:



*(Diagram NOT drawn to scale)*

### Incremental capital cost

The incremental capital cost is calculated in two stages:

$$\text{Change in quantity} = (\text{£}y + \text{£}z) - \text{£}x$$

$$\text{Capital cost} = \text{Change in quantity} \times \text{cost of capital}$$

The assumptions for the cost of capital are given in paragraph 46 below.

### Incremental funding cost

The incremental wholesale funding cost is calculated using the following formula:

$$\text{Wholesale (w/s) funding cost} =$$

$$[(\text{£}b \times \text{cost of w/s funding}_b) + (\text{£}c \times \text{cost of w/s funding}_c)] - (\text{£}a \times \text{cost of w/s funding}_a)$$

Where:

$$\text{Cost of w/s funding}_b = \text{cost of w/s funding}_a + (\text{Non-ring-fenced bank spread})$$

$$\text{Cost of w/s funding}_c = \text{cost of w/s funding}_a + (\text{Ring-fenced bank spread})$$

This equation is applied separately to each of subordinated, long-term senior unsecured and short-term senior unsecured debt. Details on the assumed changes in prices for each of these types of wholesale funding, for both the ring-fenced and non-ring-fenced banks, are given in paragraph 50 below.

35. Separately, the major affected banks were asked to provide estimates of the incremental **operational and transitional costs**. From these estimates, the Government drew ranges for the costs per bank, and calculated aggregate cost ranges across all affected banks.
36. According to this modelling approach, the breakdown of private costs of **ring-fencing** into capital, funding, operational and transitional costs is as summarised in the table below:

Ongoing Costs, per year	LOW	HIGH
Capital	£1.5bn	£3bn
Funding	-£170m	£150m
Operational	£400m	£1.2bn
<b>TOTAL ONGOING COST, per year</b>	<b>£1.7bn</b>	<b>£4.4bn</b>
Transitional Cost (one-off)	£1.5bn	£2.5bn

### Restructuring of bank pension schemes

37. To ensure the ring-fence is effective in curtailing the perceived implicit government guarantee of large UK banks, it is important to ensure the ring-fenced bank is economically independent of other entities in its banking group. In line with the ICB's recommendation and the Banking Reform White Paper, the Government will require large UK banks to ensure that a ring-fenced bank is not liable for the pension liabilities relating to other members of its group. The Bill will give the Treasury the power to make regulations requiring UK banks to separate their pension scheme liabilities such that a ring-fenced bank is not liable for the pension liabilities of other members of its banking group.

38. It is important to note that the large UK banks affected are currently running deficits both on a “buyout” basis<sup>7</sup> and an ongoing funding “technical provisions” basis<sup>8</sup> which pre-date and are independent of the Government’s ring-fencing proposals.

#### Options for restructuring of pension schemes

39. While requiring that ring-fenced banks should not be liable for the pension liabilities of other entities in its banking group, the Government intends to give as much flexibility as possible to banks and their trustees to undertake this restructuring. The Government expects the banks and their trustees to determine the optimal solution for their respective schemes and to ensure that pension schemes are restructured in a way that ensures the ring-fenced bank’s economic independence. Given this flexibility, the details of the final outcome of how each scheme will be restructured cannot be predicted by the Government.

40. The two options the Government considers most likely to be undertaken by the banks to achieve this necessary restructuring are:

- **“Splitting”** a scheme - under this scenario, a second pension scheme is established with one or more employers having assets and liabilities transferred to it from the existing scheme in a way that extinguishes their liability to the existing scheme. This would remove the potential for liabilities of the non-ring-fenced bank to fall on the ring-fenced bank and vice versa.
- **Segregation** of a scheme - this is where a pension scheme is divided into two or more separate sections that cannot be used to cross-subsidise each other. Each employer will have liability only to a particular section of the scheme that has clearly identifiable assets and liabilities.

#### Cost of separation

41. The Government believes there will be three principal costs of removing a ring-fenced bank’s liability for the pension liabilities of other entities in its banking group:

- **Initial separation cost** - an employer withdrawing from a pension scheme, or a section of a scheme, is required to pay into the scheme compensation for giving up its previous liabilities to the scheme – known as the section 75 (s. 75) debt.<sup>9</sup> But if the departing employer takes with it some or all of its previous liabilities (into a new scheme or section), its s. 75 debt may be reduced by a ‘relevant transfer deduction’. If the departing employer took its full share of the existing scheme’s liabilities, the s. 75 payment is likely to be nominal. However, the exact level of the s. 75 payment would depend on details of how each pension scheme was restructured, and the resulting negotiation between banks and their trustees on the value of any payment required. Given the uncertainties involved, it is not possible for the Government to quantify the initial separation cost, so this cost has not been monetised in this IA.
- **Ongoing impact on pension scheme covenant** - the “employer covenant” is a term used to describe an employer’s legal obligation to a pension scheme (or a section of a pension scheme) and its ability to fund the pension scheme now and in the future. The employer covenant is assessed by each scheme’s trustees. The stronger the employer covenant, the more optimistic the trustees may be about the assumptions they make for future investment income from the assets of the scheme. A stronger covenant may therefore result in a lower scheme deficit to be funded by the employer.

It is anticipated that employer covenants for each of ring-fenced and non-ring-fenced bank are likely to weaken after the corporate restructuring to separate the ring-fenced and the non-ring-fenced bank as each scheme, or section of a scheme, is now backed by fewer employers. In

---

<sup>7</sup> The amount required to buyout a pension scheme’s liabilities with an insurer.

<sup>8</sup> The amount required to ensure that the scheme will be able to pay its liabilities over the longer term assuming returns on scheme assets.

<sup>9</sup> <http://www.thepensionsregulator.gov.uk/guidance/multi-employer-schemes-and-employer-departures.aspx>.

addition, the covenant may weaken as the claims on an insolvent bank of the bank's pension scheme to settle any s. 75 pension debts triggered by the bank's insolvency, become subordinated to FSCS-protected deposits (or to the FSCS standing in their place) in insolvency (see paragraphs 55-59 below for the impact of depositor preference).

How far the covenant is affected will however depend on the exact details of how each scheme is restructured, which cannot be predicted in advance. In addition, the extent to which a weakening of the covenant will lead to higher costs to banks is dependent upon the negotiation between banks and their trustees, which is uncertain. Given this uncertainty, it is not possible for the Government to model these costs and so they have not been monetised in this IA.

- **Administrative cost** - there will be one-off costs associated with the segregating or splitting of the liabilities to the pension scheme, including costs such as legal, actuarial and administration fees. Estimates provided by the large UK banks and the trustees of their pension schemes suggest this impact would be no greater than £50m across all the affected banks in relation to the ring-fencing of the pension liabilities.

### *Assumptions, risks and sensitivities: Ring-fencing*

#### Ring-fencing requirements determined by secondary legislation and regulatory rules

42. As noted above (paragraphs 14-16), the enabling nature of the Banking Reform Bill requires a number of assumptions to be made about the content of secondary legislation and regulatory rules in order to model the design and impact of the ring-fence. For the purposes of this IA, it was generally assumed that secondary legislation and rules would follow the policy set out in the Banking Reform White Paper.
43. Exceptions to this were the definitions used for SMEs and private banking customers (necessary to determine which deposits had to be placed within the ring-fence, and which could be placed either side), and the assumptions used to model the geographical scope of the ring-fence. For the definition of SMEs and private banking customers, the banks lacked the data needed to use Government-prescribed assumptions, so had to use proprietary definitions instead. The affected banks expressed a view, however, that the impact on the balance sheet scenarios of using these definitions instead of prescribed assumptions would be minimal.
44. As for the geographical scope of the ring-fence, as discussed in the Banking Reform White Paper, the Government proposes to implement the ICB's recommendation that ring-fenced banks should not serve customers outside the EEA by prohibiting them from establishing non-EEA branches or subsidiaries. To model the impact of this prohibition, given limitations on the data available to them, banks used the booking location of transactions to determine which assets and liabilities could be placed within the ring-fence and which had to be outside it.
45. A full list of the assumptions made about the content of secondary legislation and rules for the ring-fence modelling scenario is set out at Annex A below.

#### Equity capital assumptions

46. For the annual cost of equity capital, an assumed range of 8 per cent – 16 per cent has been used, a range based around a long-run historical average cost of equity<sup>10</sup> to banks of 11.5 per cent, used by the FSA.<sup>11</sup>
47. It has also been assumed that the additional capital required to comply with ring-fencing is available to banks. The Government estimates that the total amount of extra equity required by UK banks is approximately £19bn. Banks have a range of options for increasing their equity levels, including raising capital externally (for example by issuing new shares) and generating equity internally through retained earnings. With several years until the final deadline for compliance, the Government is confident that banks will be able to raise the additional equity required.

---

<sup>10</sup> Rather than the opportunity cost of equity over debt.

<sup>11</sup> 'Strengthening Capital Standards 3 - further consultation on CRD3', FSA consultation paper CP11/09.

48. To reflect the likelihood that bank managements would in practice operate a little above regulatory minimum capital requirements, the Government asked the banks to assume a management buffer of 1% of risk-weight assets (RWAs) above the regulatory minimum, and a management buffer of 2% of RWAs above their regulatory PLAC requirement.

### Wholesale funding cost assumptions

49. The impact of ring-fencing on banks' funding costs is difficult to forecast precisely. As discussed in paragraph 32 above, it is likely that funding costs for ring-fenced banks will fall, while funding costs for non-ring-fenced banks will rise as a result of ring-fencing. Meanwhile, both ring-fenced and non-ring-fenced banks may experience a loss of diversification in their revenues, which may push funding costs up. Changes in banks' balance sheet structures may also affect the annual cost of funding by changing the amount of wholesale funding that different banks require.

50. In modelling the impact of ring-fencing on funding costs, the Government has used estimates provided by the major UK banks of the likely effect on their funding costs, as well as drawing on external analysis. On the basis of this information, for the purposes of this IA the Government has used the following assumed ranges:

- For ring-fenced banks: a change of between -10 basis points (bps) and 0bps in the cost of subordinated, long-term unsecured and short-term unsecured debt.
- For non-ring-fenced banks: a change of between 0bps and 75bps in the cost of subordinated, long-term unsecured and short-term unsecured debt.

51. It is important to note that these estimated impacts on banks' funding costs do not include the impact of bail-in. This is because the Bill does not include provision for a bail-in tool: as noted in paragraph 7 above, it is expected that bail-in will be implemented via transposition of the European RRD. This is one area of difference between the cost estimates in this IA and those in the IA accompanying the Banking Reform White Paper, which covered the full ICB package, including bail-in.<sup>12</sup>

### Operational costs and tax implications

52. Based on estimates supplied by banks, the Government has assumed that operational costs for the large UK banks of complying with ring-fencing range from £100m - £300m per bank per year. Costs are likely to vary depending on banks' business models, including their choices over the location of the ring-fence.

53. The Government has identified potential tax implications of implementing the ring-fence, including how banks use their trading losses to offset profits in future years (as ring-fenced banks will be separate entities from non-ring-fenced banks) and the impact of removing ring-fenced banks from their VAT groups. The Government is continuing to consult with industry on options to mitigate the potential costs of these tax implications, and expects to bring forward measures in a future Finance Bill. The costs arising from tax policy are out of scope of this IA any case, as this assesses only the costs and benefits of regulation not tax.

### Transitional costs

54. The costs of restructuring to comply with ring-fencing are likely to vary from bank to bank, depending on their chosen post-ring-fencing business model. The Government, using estimates provided by the large UK banks, has assumed a range of restructuring costs for the large UK banks of £50m-£500m per bank.

---

<sup>12</sup> The White Paper IA estimated the total private cost to UK banks of the whole ICB package as falling in the range £4bn-£7bn per year and the GDP cost in the range £0.6bn-£1.4bn per year. The electronic version of the Banking Reform White Paper and accompanying IA can be found at [http://www.hm-treasury.gov.uk/fin\\_stability\\_regreform\\_icb.htm](http://www.hm-treasury.gov.uk/fin_stability_regreform_icb.htm).

## Depositor preference

### *Summary of private cost*

55. The Government estimates that the aggregate private cost of depositor preference to UK banks will be in the range £0.3bn-£0.7bn per year.

### *Modelling the private cost of depositor preference*

56. Preferring FSCS-protected deposits (and thus the FSCS standing in their place) in the event of a bank becoming insolvent will likely reduce the expected recovery of the bank's other (current) senior unsecured creditors, who will likely demand a higher price to compensate them for the increased risk in lending to the bank. Thus the cost of wholesale funding for the bank will likely rise.

57. To model the cost of depositor preference, the Government asked the major UK banks to estimate the impact on the cost of short-term unsecured funding of preferring FSCS-insured deposits. From the estimates supplied, the Government drew a range for the basis point impact, from 25bps to 50bps. Applying this to the quantities of short-term funding included in each bank's modelled balance sheets gave the annual cost, which was then aggregated across all the major UK banks.

58. Depositor preference is, however, just one element of the ICB's recommendations on loss-absorbency that is expected to impact on banks' costs of wholesale funding. For example, a bail-in tool would also expose senior unsecured creditors to greater risks of loss, increasing banks' funding costs. To some extent, these additional costs may also be offset by the effects of behavioural responses by customers, for example if depositor preference made customers more willing to place deposits in banks at lower rates of interest, reducing the cost to banks of deposit funding. Such behavioural effects are, however, uncertain and difficult to forecast with any precision, so monetisation of these costs has not been attempted in this IA.

59. Isolating the impacts on banks' funding costs of different elements of the ICB's recommendations is difficult, and requires that assumptions be made about which portions of an increase in funding costs should be attributed to which particular measures. Given the overlapping impacts of the different policy measures, any assumption made would be to some extent subjective. For the purposes of this IA,<sup>13</sup> the costs were attributed by modelling the costs of a bail-in tool as falling on long-term senior unsecured debt,<sup>14</sup> and the costs of depositor preference as falling on short-term unsecured funding. As noted above, the Bill does not include a bail-in tool (which the Government intends to deliver via transposition of EU legislation), so the cost of bail-in is not included in this IA.

## Framework for imposition of debt requirements

### *Summary of private cost*

60. The ICB recommended that large banks be required to maintain Primary Loss-Absorbing Capacity (PLAC) of at least 17 per cent of RWAs, consisting of regulatory capital plus debt that is clearly subject to bail-in.<sup>15</sup> Minimum regulatory capital requirements will be set in EU law (CRD IV/CRR, which will implement the Basel III minimum capital requirements in the EU). It is expected that the European RRD will also require member states to impose requirements on banks to hold minimum levels of loss-absorbing instruments: the Government expects that this will be the means by which the ICB's recommendation on PLAC will be delivered.

61. The Bill will give HM Treasury power to establish the framework for the regulator to impose minimum debt requirements, subject to the final form of the RRD. Establishing a framework for regulatory action is not

---

<sup>13</sup> As well as for the purposes of the Government's previous modelling of the costs of the entire ICB package, as set out in the IA accompanying the Banking Reform White Paper.

<sup>14</sup> 'Long-term' being defined as with a maturity of one year or more.

<sup>15</sup> Provided they satisfied minimum regulatory capital requirements, banks would have the choice to meet any shortfall between these capital requirements and their PLAC requirement through holding additional regulatory capital or eligible debt instruments.

expected of itself to impose any additional costs on UK banks (and when exercising its powers, the regulator will need to consider the costs and benefits of any potential course of action).

### *Assumptions, risks and sensitivities: Framework for debt requirements*

#### Regulatory assumptions on loss-absorbency

62. To be able to model their balance sheets in a ring-fencing scenario, it was necessary for banks to make assumptions about the minimum requirements for regulatory capital and PLAC. For the purposes of this modelling, therefore, the Government asked all the major UK banks to assume minimum loss-absorbency requirements equal to the Basel III minima for capital and 19 per cent of RWAs for total PLAC (equal to a regulatory minimum of 17 per cent plus a 2 per cent 'management buffer' above this minimum). More detail on the assumptions for loss-absorbency is included in Annex A below.

#### General assumptions for modelling private cost to banks

##### Static modelling of bank balance sheets

63. The modelling of banks' balance sheets for the purposes of this IA was static, i.e. it took no account of potential behavioural responses by either bank management or bank customers. So the only changes to banks' balance sheets were those required to comply with ICB requirements or to meet perceived market expectations (for example sufficient capital to ensure a bank could attain a high enough credit rating in order to operate effectively in the market: in both baseline and ring-fence scenarios, some banks assumed that market pressures would require them to hold capital above regulatory minima).

64. In practice there may be more extensive behavioural responses both from customers (switching between banks, or between ring-fenced and non-ring-fenced banks) and from banks (adjusting their business lines in response to market dynamics and the actions of competitors). These behavioural responses are inherently uncertain, and so difficult to quantify with confidence. No account has therefore been taken of these behavioural responses in modelling for this IA.

##### Crisis response and stress

65. For the purposes of this IA, modelling has focussed exclusively on the long-run costs of the measures in the Bill in a 'steady state', i.e. when markets are functioning normally. It is not possible to model with any precision the impact of these measures in a stress scenario, as defining what constitutes a stress scenario, and determining the extent to which such a scenario has an effect on different banks in the market, are subjective and highly sensitive to assumptions. The impact of these measures in a stress scenario will also likely vary significantly from bank to bank.

66. In theory, curtailing the perceived implicit government guarantee should exaggerate the movement of funds in a stress from banks perceived by market participants as high risk to those perceived as less risky. Such movement could be seen as encouraging more efficient pricing of funds in a stress, and could lower the cost of funds for low-risk banks. At the same time, ring-fencing should make individual banks and the system as a whole more resilient to stress, as a result of higher capital levels and reduced channels of contagion between banks. This should reduce the extent to which funding costs would rise in a stress scenario. There are, however, too many uncertainties involved for meaningful modelling of these different effects, which are therefore excluded from this IA.

## *Social cost (cost to GDP)*

### *Summary of GDP cost*

67. The increase in banks' private costs is estimated to produce a gross<sup>16</sup> reduction in the long-run level of GDP in the range 0.04% to 0.1%, equivalent to an average<sup>17</sup> annual cost to GDP of £0.4bn - £1.1bn relative to the 'regulatory environment' baseline scenario. The present value cost to GDP is estimated at £7bn - £20bn.

### *Modelling the cost to GDP*

68. Having estimated the aggregate private cost to UK banks of implementing the measures in the Bill, the Government then estimated the impact of these costs on GDP from modelling by the FSA using the NiGEM model. NiGEM is an empirically-based econometric model that estimates the impact on economic output as a result of changes to banks' minimum capital ratios, funding and operational costs. The model uses long-run historical data that capture the various channels (e.g. changes in the consumption behaviour of economic agents such as bank customers or bank shareholders) through which changes to bank private costs transmit to changes in GDP. Paragraphs 23-24 above describe how the GDP cost arises in more detail.

### *Assumptions, risks and sensitivities*

#### NiGEM modelling of long-run GDP cost

69. NiGEM calculates the GDP cost on the assumption that banks pass on to consumers near to 100% of the additional private costs to banks, reflecting the historical data that underpins the model. This suggests that little, if any, private costs will directly transmit to banks' profits.<sup>18</sup> The Government recognises that using historical evidence may not truly reflect future trends, and so the pass through in the future may not be the same. Also, how banks pass on any increase in their private costs is a commercial decision and so cannot be forecast with certainty.

#### Calculating present value of GDP cost

70. The present-value GDP cost presented in this IA has been calculated using the annual GDP cost estimate in paragraph 67. The annual GDP cost is calculated using the following assumptions about when the different costs that banks face arise:

- transitional costs are incurred in the first two years of the transition period of the policy;
- operational ongoing costs are zero in the first two years, but are then constant each year thereafter;
- capital costs increase steadily year on year until reaching the point at which banks hold sufficient capital to meet the policy requirements by the deadline for compliance in 2019. From this point, the capital costs are constant each year; and
- funding costs increase steadily year on year over the transition period until 2019, after which they are constant year on year.

71. The Government's intention is for the measures in the Bill to constitute a permanent reform to the banking sector. For the purpose of calculating the present value GDP cost and benefit, the annual GDP costs and benefits have been assumed to persist for 30 years, discounted according to HM Treasury Green Book guidance. The Government recognises that the present-value costs and benefits of the policy will extend (albeit at diminishing levels) beyond the 30-year policy period chosen.

---

<sup>16</sup> i.e. not taking account of the benefits to GDP of the measures in the Bill.

<sup>17</sup> Over a 30-year forecast period: see 'Calculating present value of GDP cost' section.

<sup>18</sup> Though there could be a second-round indirect impact on bank profits to the extent that higher prices reduce demand for banks' products.

## Short-run GDP impact

72. In the long run, by making UK banks more resilient and resolvable and thus curtailing the perceived implicit government guarantee, implementing the measures in the Bill are expected to support more efficient supply of credit to the economy. There is a risk that in the short term however, banks could respond to the new regulations, in particular higher capital requirements, by shrinking their balance sheets and cutting back lending to the real economy to meet the capital requirements. External estimates suggest that there can be a cost to GDP when banks are required to increase capital requirements in a short period of time.<sup>19</sup>
73. The Government has established 2019 as the final deadline for compliance with ring-fencing, in line with the ICB's recommendations. This will give UK banks several years in which to raise the additional capital required (as well as to implement the necessary restructuring). As noted in paragraph 47 above, UK banks will have a range of options for raising additional capital. The Government therefore believes that the extended timetable for compliance proposed by the ICB will mitigate the risks of banks deleveraging significantly in the short term in response to the new regulations.

## *Cost to the Exchequer*

### *Summary of Exchequer cost*

74. Implementing the measures in the Bill is estimated to produce a gross **reduction in tax receipts of £150m-£400m per year** and a **reduction in the value of the Government's shareholdings in partially publicly-owned banks of £2bn-£5bn**, relative to the 'do nothing' baseline.

### *Tax receipts*

75. In the long run, the main driver of the level of annual tax receipts is the level of GDP: all else being equal, lower GDP would therefore result in lower tax receipts for the Exchequer. Having estimated the impact on GDP of the measures in the Bill as described above, the Government estimated the impact on tax receipts by applying the long-run average tax to GDP ratio (35.2 per cent over the last 20 years). This gives a reduction in tax receipts of £150m-£400m per year.
76. This approach assumes that banks pass on 100 per cent of the additional costs to customers (as assumed for the NiGEM modelling), and that the impact on tax receipts is all therefore felt through the impact on GDP. It is possible, however, that banks may choose to internalise some of the additional costs, pushing down their profits, or to pass them on to employees instead, pushing down their pay. These possible effects could push down receipts from corporation tax and income tax/NICs respectively. The extent to which banks do internalise costs (or pass them on to employees) will be a commercial decision for managements, which the Government cannot forecast with certainty. However, it is not clear that there would be a marked difference in total tax receipts if some of the additional costs were to be passed through to bank profits or bankers' remuneration, as in these circumstances the pass-through of costs to customers (and thence to GDP and wider tax receipts) would be reduced, which may offset any reduction in tax receipts specifically from banks or their employees.

### *Government shareholdings in RBS and Lloyds Banking Group*

77. The additional costs of the measures in the Bill are likely to impact on the value of the Government's stakes in RBS and Lloyds Banking Group, although this effect may be to some extent mitigated if equity investors perceive them to be less risky following the reforms. To the extent that proceeding with the Bill reduces the eventual proceeds from selling the Government's shareholdings, there will be an additional cost to the public finances, which will crystallise when the shareholdings are sold.
78. The Government has used estimates provided by UK Financial Investments Ltd (UKFI) to assess the potential loss to the value of its shareholdings arising from the measures in the Bill. These estimates are based on

---

<sup>19</sup> For example, "Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements", Basel Committee on Banking Supervision, December 2010.

standard bank valuation methodologies, using various assumptions about the potential impact on the banks' return on equity (which will be affected by changes to their funding and operating costs, amongst other factors), cost of equity and additional capital requirements. It is important to note that this loss is not relative to the current market value of the Government's shareholdings in RBS and Lloyds Banking Group. Rather, the estimated loss attributable to the Bill is relative to the counterfactual future scenario in which the Bill measures are not implemented (consistent with other cost and benefit estimates in this IA). With markets anticipating that the Government will implement the recommendations of the ICB (including the measures in the Bill), it is likely that the impact is already largely or entirely factored into the two banks' current market share prices.

79. UKFI's estimates of the value impact are subject to a range of caveats. First, in line with the rest of this IA, they do not take account of the costs to banks of bail-in, as this is not included in the Bill. Also consistent with the approach taken elsewhere in this IA, the modelling does not take account of any behavioural responses by bank management (e.g. reconfiguring business lines) or customers (e.g. switching banks), as such effects cannot be estimated with any confidence. It also assumes that there is no pass through of costs to customers: given that the Government's estimate of the impact on GDP of the Bill measures does assume that costs are passed through, there is therefore likely to be some double-counting of costs. Given these limitations, the UKFI estimates should be viewed as broadly indicative of the maximum extent of shareholder costs, rather than precise forecasts. On the basis of these assumptions, the Government estimates that the measures in the Bill could lead to a reduction in the value of the Government's shareholdings in RBS and Lloyds of around £2bn-£5bn.

## Benefits of option 2: Proceed with Banking Reform Bill

### *Economic benefits of increased financial stability*

80. The aim of the Bill is to promote greater financial stability in the UK, by curtailing the perceived implicit government guarantee to banks. Curtailing the perceived implicit guarantee will reduce banks' incentives to take on excessive risks, tackling the moral hazard that the perception of a guarantee creates. Curtailing the perceived implicit guarantee should bring a benefit to the Government's borrowing costs, as sovereign debt investors perceive a reduction in the Government's contingent liability to the banking sector (that is, a reduced likelihood of the Government needing to use public funds to support failing banks in a future financial crisis).
81. The measures in the Bill will also make banks more resilient to shocks (reducing the likelihood of bank failure) and more easily resolvable in the event of failure (reducing the impact on the economy and the public finances of bank failure). This should therefore make banking crises less frequent and less costly to the economy in the future, resulting in a higher level of GDP in the long run (and as a consequence, all else being equal, higher tax receipts). Independent of the level of GDP, there is likely to be a welfare benefit from a more stable path for GDP, as individuals and firms value stability of income as well as income levels. Greater stability of GDP could also increase confidence in the economy and provide a better environment for investment.

### *Challenges in quantifying the benefits of increased financial stability*

82. The precise costs of financial instability (and hence the benefits of greater stability) are, however, inherently uncertain, as they depend on how often financial crises will occur in the future, and what form those crises will take, which cannot be known in advance. In its final report, the ICB quoted a survey of academic estimates of the annual GDP cost of financial crises compiled by the Basel Committee on Banking Supervision (BCBS). According to the figures in this academic literature, the maximum range for the annual GDP cost is very wide, from 0.58 to 15.7 per cent of GDP.<sup>20</sup> It is, however, clear that systemic financial

---

<sup>20</sup> ICB *Final Report*, paragraph 5.8. The ICB quoted BCBS 2010, *An Assessment of the Long-term Economic Impact of Stronger Capital and Liquidity Requirements*. In the literature surveyed by the BCBS, estimates of the probability of a financial crisis occurring in a given year ranged from 3.6 to 5.2 per cent, and estimates of the net present value cost to GDP of a crisis occurring ranged from 16 to 302 per cent. Multiplying lowest by lowest and highest and highest gives a maximum range for the annual cost to GDP ranging from 0.58 to 15.7 per cent of GDP.

crises can be extremely costly when they do occur, both to GDP and to the public finances. Drawing average values from the academic literature surveyed by the BCBS, the ICB estimated the annual cost of financial crises at approximately 3 per cent of GDP, or around £40bn in 2010 terms.<sup>21</sup>

83. The experience of the 2008-09 financial crisis further illustrates how large the costs of financial instability can be. According to the Office for Budget Responsibility (OBR), the crisis of 2008-09 led to a peak-to-trough fall in GDP of 7.1 per cent,<sup>22</sup> and the OBR forecast that potential output in 2016 will be 11 per cent below its extrapolated pre-crisis trend.<sup>23</sup> During the crisis, as GDP, and with it tax receipts, fell sharply, public spending (based on the plans set out in the 2007 Comprehensive Spending Review) increased rapidly as a share of GDP, which caused a sharp deterioration in the public finances. In addition, the public finances faced the very substantial costs of direct support to the UK financial system, which at peak amounted to over £120bn in cash support and a further £1tn in guarantees and contingent liabilities.<sup>24</sup>

### *Illustrative calculations of benefits of improved financial stability*

84. 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.
85. Using the ICB's method for quantifying the annual GDP cost of financial crises, it is possible to show the scale of the benefits to GDP that a reduced likelihood or output cost of financial crises (that is, an increase in financial stability) would bring. An illustrative calculation of this sort was included in the IA accompanying the June 2012 Banking Reform White Paper.
86. This calculation began with the ICB's estimate of the annual cost of financial crises. It first assumed that wider regulatory reforms (such as those included in the 'do nothing' baseline option) would reduce this annual cost by 30 per cent. From this baseline, if implementing the ICB's recommendations further reduced the probability of future crises by 10 per cent (by making the banking system more resilient) and reduced the GDP impact of crises by 25 per cent (by making banks more resolvable in the event of failure), this would yield an incremental benefit to UK GDP of 0.64 per cent, which would be equivalent to £9.5bn in 2010-11 GDP terms.<sup>25</sup>
87. This illustrative calculation can be adjusted to reflect the exclusion from this IA of those elements of the ICB's recommendations not included in the Bill (for example bail-in). Assuming the same baseline estimates for the starting GDP cost of financial crises and for the impact of baseline regulatory changes, if the measures in the Bill further reduced the probability of crises by 10 per cent and the GDP impact of crises by 15 per cent, this would yield an incremental benefit to UK GDP of 0.47 per cent, which would be equivalent to **£6.9bn** in 2010-11 GDP terms.

### Sensitivity analysis for illustrative calculation

88. An illustrative calculation of this sort is naturally sensitive to the assumptions used. A particular sensitivity is to the value used in the starting estimate of the annual GDP cost of crises for the present value GDP cost of a crisis when one does occur. If, instead of the average value calculated by the ICB (63 per cent), the maximum value included in the academic literature (302 per cent) is used, the annual cost of crises calculated using the ICB's method rises to 14 per cent of GDP. If the cost of crises is higher, then so will be the benefit of greater stability: if this higher starting cost of crises is used as an input to the illustrative

---

<sup>21</sup> ICB *Final Report*, paragraph 5.8 and 5.67. From the literature surveyed by the BCBS, the ICB drew average values for the probability of crises in a given year (4.5 per cent) and the net present value output cost of a crisis occurring (63 per cent). Multiplying these gives an estimated annual cost of 2.8 per cent.

<sup>22</sup> *Economic and Fiscal Outlook*, OBR November 2011.

<sup>23</sup> *Economic and Fiscal Outlook*, OBR March 2012.

<sup>24</sup> *The Comptroller and Auditor General's Report on Accounts to the House of Commons: The Financial Stability Interventions*, National Audit Office, July 2011.

<sup>25</sup> Banking Reform White Paper Impact Assessment, paragraph 91.

calculation described in paragraph 88 above, the incremental annual benefit of the measures in the Banking Reform Bill rises to 7.3 per cent of GDP, or £33bn in 2010-11 GDP terms.

89. Conversely, if the lowest value in the academic literature for the present value cost of a crisis (16 per cent of GDP) is used in the same illustrative calculation, the incremental annual benefit of the Bill measures falls to 0.39 per cent of GDP, or £1.75bn in 2010-11 GDP terms. Note that even this lower value still results in a net benefit compared to the estimated annual GDP cost of the Bill measures.
90. The illustrative calculation is also somewhat sensitive to the assumed reduction in the frequency and GDP impact of crises produced by the 'baseline' regulatory reforms and by the measures in the Bill. All else equal, each 1 percentage point increase in the assumed benefit of regulatory reforms in the baseline would reduce the incremental GDP benefit of the Bill measures by around 0.02 percentage points or £100m in 2010-11 GDP terms. If the baseline reforms assumption is held constant, then each 1 percentage point change in the impact of the Bill measures on the frequency and GDP impact of future crises would cause the incremental benefit to change by 0.017 percentage points and 0.018 percentage points (£250m and £260m in 2010-11 GDP terms), respectively.
91. Despite this sensitivity to assumptions, it is clear that given the very large scale of the costs to the economy of financial crises, even relatively modest increases in financial stability can yield significant benefits to GDP. To illustrate this further, it is possible to calculate the least impact on financial stability that the measures in the Banking Reform Bill need have for them still to yield a net benefit to GDP. Assuming the same starting cost of crises and impact of baseline regulatory reforms as used in paragraph 87 above, in order to produce an incremental benefit to GDP of 0.1 per cent (the upper end of the estimated range of GDP costs), the measures in the Bill need only reduce the probability of future crises by 2 per cent and their GDP impact by 2 per cent.

## Conclusion on costs and benefits of Banking Reform Bill

92. Given the measures in the Bill are intended to reduce the probability and severity of future financial crises, and that such crises are very costly to the UK economy, the Government concludes that the benefits of proceeding with the Bill outweigh the costs, and thus that proceeding with the Bill will generate net benefits relative to the baseline (Option 1).

## Rationale and evidence that justify the level of analysis in this IA

### *Proportionality*

93. The measures included in the Banking Reform Bill are the product of extensive policy development and consultation by both the ICB and the Government over a period of more than 2 years. During this period, a wide range of alternative approaches have been considered, including alternative models for structural reform of banks (e.g. full separation of retail and investment banking, full reserve banking and narrow banking considered by the ICB) and different options for the calibration of the ring-fence and depositor preference (e.g. alternative calibrations considered for the Government's Banking Reform White Paper).
94. With these alternatives having been discarded at earlier stages, analysis for this IA has focussed exclusively on the impact of the measures included in the Bill, which have been compared to a 'Do Nothing' alternative.

## Wider impacts

95. There are a number of wider impacts that have been considered. These are detailed below.

### *Impact on competition in the UK banking sector*

96. Reducing the perceived implicit government guarantee for large UK banks that are seen as 'too big to fail' should support competition in the UK banking sector, as the perceived implicit guarantee gives a competitive advantage to large banks over smaller competitors, who are not seen as benefiting from an implicit guarantee. Reducing the perceived implicit guarantee will thus reduce the competitive disadvantage for smaller banks and should support greater competition in the market.

### *Distribution of the impact in the market*

97. The aggregate private costs to the banking industry are £2bn–£5bn. The cost to each bank in the industry as a result of the policy option will be different, as they have different business models. There is, however, some flexibility in how banks can adjust their businesses to the requirements of ring-fencing, which gives them scope to find an optimal business model. It is not possible to disaggregate the impact for each of the UK banks affected, as this is commercially sensitive data.

### *Impact on the labour market*

98. Imposing additional costs on UK banks could have consequences for the labour market, to the extent that banks choose to pass higher costs on to their employees by reducing overall remuneration levels. However, it is not clear whether, or to what extent, banks will in fact pass costs on to employees: this would be a commercial decision for each bank, which it is not possible for the Government to forecast with any certainty.

### *Business borrowing distortions*

99. An increase in banks' private costs may lead to an increase in lending rates. Larger businesses that are not reliant upon funding through these banks, and can access funds from alternative sources, would be less affected by the increase in bank lending costs than smaller businesses that may be more dependent on funding from banks. Whether and how banks choose to pass on additional costs to their customers is a commercial decision for each bank, which it is not possible for the Government to forecast with any certainty.

### *Impact on competitiveness of UK banking sector*

100. The Government believes that the measures in the Banking Reform Bill will enhance competitiveness in the UK financial sector in the long run, through greater financial and macroeconomic stability. It is imperative that such regulatory reform is introduced to make the UK banking sector more stable and intervention at the taxpayers' expense less likely in future.

### *Expected finance and resource impact on other Departments*

101. Enforcing and policing the ring fence will incur costs to the Prudential Regulation Authority (PRA). The FSA has estimated that the upfront cost of implementing the ICB's recommendations to the regulator to be no more than £20m, with subsequent ongoing costs of around £2m per annum. The costs of enforcing just the elements of the ICB's recommendations included in the Bill will likely be somewhat lower.

### *Equality impact*

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

103. The Government considers that the proposals are compatible with the Convention rights protected under the Human Rights Act 1998.

### ***Exemption from One-in-One-out rule***

104. The measures the Government is introducing through the Banking Reform Bill deal with the issue of financial systemic risk. As noted above in the 'Introduction', the measures in the Bill will make UK banks and the UK banking sector as a whole more resilient to shocks (reducing the likelihood of bank failure) and more easily resolvable in the event of failure (reducing the impact on the financial sector, the public finances and thus the economy). The measures specifically intend to reduce systemic risk in the UK banking sector by increasing UK financial stability. There is an exemption for measures dealing with systemic financial risk from the Better Regulation Executive's One-in-One-Out Rule,<sup>26</sup> so the measures in this IA are therefore out of scope of the rule.

### ***EU Minimum Requirements***

105. The Government considers that the ring-fencing and depositor preference policy measures do not go beyond minimum requirement of existing EU law as there is currently no EU legislation in force concerning the separation of retail from wholesale banking activities or legislation to prefer bank depositors in the case of bank insolvency. The Government does however recognise the current and ongoing discussions concerning these policy areas at an EU level, for example the recently published Liikanen report on structural reforms.

106. In addition, the Banking Reform Bill does not set out minimum requirements for banks' regulatory capital or PLAC. As outlined in Annex A, the Government has made modelling assumptions for minimum regulatory capital and PLAC requirements. In some cases however, the modelling assumptions used may go beyond the assumed EU minima.<sup>27</sup> The modelling assumptions have been made in line with Government policy that was set out in the Banking Reform White Paper, but are not measures included in the Banking Reform Bill.

## **Summary and implementation plan**

### ***Chosen policy option***

107. The Government therefore proposes to implement the measures in the Bill (Option 2). The Government believes that implementing these measures will deliver net benefits relative to the baseline (Option 1).

### ***Implementation plan***

108. This IA reflects the ICB recommendations that the Government will be implementing through the Financial Services (Banking Reform) Bill, having been through a period of pre-legislative scrutiny by the Parliamentary Commission on Banking Standards.

109. As noted in paragraph 16 above, when secondary legislation under the Bill is brought forward for consultation later in 2013, this will also be accompanied by further IAs.

---

<sup>26</sup> <http://www.bis.gov.uk/assets/biscore/better-regulation/docs/o/11-671-one-in-one-out-methodology.pdf>

<sup>27</sup> CRDIV and RRD address these minimum requirements for the EU, which at the time of publication, had not been finalised.

## Annex A

### *Assumptions on secondary legislation and regulatory rules*

Listed below are the assumptions the Government has made in its modelling for this IA of the requirements that will be imposed by secondary legislation and rules. The assumptions below do not necessarily reflect the Government's final position in these areas.

#### Ring-fencing:

Issue	Modelling assumption for this IA
<i>De minimis</i> exemption from ring-fencing	Banks with core deposits of less than £25bn exempt from ring-fencing.
Core ('mandated') Services	Accepting deposits (except from non-SME organisations and high-net-worth individual private banking customers) is the only core activity (i.e. may only be carried out by Ring-fenced banks (RFBs) or banks exempt from ring-fencing).
Definition of SME	Banks made own assumptions
Definition of private banking customer	Banks made own assumptions
Excluded ('prohibited') Services	RFBs prohibited from dealing in investments as principal, entering into derivatives contracts, or underwriting securities issues. RFBs prohibited from non-EEA business and transacting with financial institutions, other than for risk management and payments purposes.
Permitted Services	Permitted services are those that are not 'core' or 'excluded' as defined by the Bill, and may be undertaken by either ring-fenced or non-ring-fenced banks. RFBs may deal in investments as principal and enter into derivative contracts for the purposes of hedging risks arising from banking activities and/or for purposes of liquidity management. RFBs permitted to offer simple risk-management products to customers, subject to safeguards. <sup>28</sup>
Geographical scope of ring-fence	Booking location of transactions used as proxy for ban on RFBs establishing non-EEA branches/subsidiaries: no assets/liabilities booked outside EEA permitted in RFBs.
Status of Channel Islands	Channel Islands treated as within EEA for purposes of ring-fence geographical scope.
Restrictions on RFB exposure to financial institutions	RFBs prohibited from providing services to any financial institutions except those that are SMEs.
Intra-group exposure limits	Exposures between RFB and rest of group subject to standard large exposure limits i.e. may not exceed 25% of regulatory capital.
Wholesale funding limit for RFBs	No more than 50% of RFB funding can be wholesale.

<sup>28</sup> This modelling assumption has been made in line with the policy set out in the June 2012 Banking Reform White Paper. At the publication of the draft Banking Reform Bill, the Chancellor wrote to the Parliamentary Commission on Banking Standards, to request their views on whether RFBs should be permitted to offer simple risk-management products to their customers. As discussed in the IA accompanying the June 2012 White Paper, the impact on *static* modelling of banks' balance sheets of prohibiting derivatives would be relatively small: the principal impact is likely to be behavioural, for example if business customers chose to move their other business to non-ring-fenced banks.

Loss-absorbency:

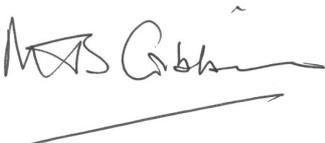
Issue	Modelling assumption for this IA
Regulatory capital requirements	<p>Basel III minimum requirements:</p> <ul style="list-style-type: none"> <li>• Min Common Equity Tier 1 (CET1) ratio: 7% RWAs (=4.5% 'hard' minimum plus 2.5% Capital Conservation Buffer);</li> <li>• Min Tier1 ratio: 8.5% RWAs;</li> <li>• Min Total Capital ratio: 10.5% RWAs.</li> </ul> <p>G-SIB surcharge:</p> <ul style="list-style-type: none"> <li>• Min CET1 ratio increased by 2.5%.</li> </ul> <p>Ring-Fence Buffer (for UK RFBs):</p> <ul style="list-style-type: none"> <li>• Min CET1 ratio increased by 3%. (where a UK RFB is also a G-SIB, the higher of the two additional capital requirements will apply)</li> </ul> <p>Leverage Ratio:</p> <ul style="list-style-type: none"> <li>• Min Tier 1 Capital to Total Exposures: 3%.</li> </ul>
PLAC requirement	Regulatory minimum PLAC (=regulatory capital plus best-quality loss-absorbing debt) ratio: 17% RWAs;
Assumed PLAC and capital 'management buffers'	<p>In addition to the regulatory minimum PLAC level of 17%, banks hold a PLAC 'management buffer' of 2% RWAs.</p> <p>In addition to the regulatory capital requirements, banks hold a capital 'management buffer' of 1% RWAs.</p>
PLAC requirement for UK-headquartered G-SIBs	Total PLAC requirement applies at Group level for UK G-SIBs, but with exemption for overseas RWAs where overseas operations do not threaten EEA financial stability.

# B

## Regulatory Policy Committee's certificate

---

**B.1** See overleaf for the Regulatory Policy Committee's certificate confirming the Government's impact assessment is fit for purpose.

 <b>Regulatory Policy Committee</b>	<b>OPINION</b>	
<b>Impact Assessment (IA)</b>	Financial Services (Banking Reform) Bill	
<b>Lead Department/Agency</b>	HM Treasury	
<b>Stage</b>	Final	
<b>Origin</b>	Domestic	
<b>IA Number</b>	Not provided	
<b>Date submitted to RPC</b>	09/01/2013	
<b>RPC Opinion date and reference</b>	21/01/2013	RPC12-HMT-1665
<b>Overall Assessment</b>	<b>GREEN</b>	
<b>Overall comments on the robustness of the OIOO assessment</b>		
<p>The IA is fit for purpose. The IA states that this proposal deals with financial systemic risk as it will make UK banks and the UK banking sector more resilient to shocks and the economic effects more easily resolvable in the event of failure. This appears a reasonable assessment in accordance with the current One-in, One-out Methodology (paragraph 16 xiv). This proposal is therefore out of scope of 'One-in, One-out'.</p>		
<b>Overall quality of the analysis and evidence presented in the IA</b>		
<p>Whilst the majority of the impacts of the policy have been monetised the IA does not include an estimate of the cost to business of restructuring pension schemes. The total costs of restructuring pension schemes are highly uncertain.</p> <p>The IA would have benefited from containing a discussion of the alternative options considered by the Financial Services Board for strengthening financial services regulation.</p>		
<b>Signed</b>		<b>Michael Gibbons, Chairman</b>

Published by TSO (The Stationery Office) and available from:

**Online**

[www.tsoshop.co.uk](http://www.tsoshop.co.uk)

**Mail, telephone, fax and email**

TSO

PO Box 29, Norwich NR3 1GN

Telephone orders/general enquiries: 0870 600 5522

Order through the Parliamentary Hotline Lo-Call 0845 7 023474

Fax orders: 0870 600 5533

Email: [customer.services@tso.co.uk](mailto:customer.services@tso.co.uk)

Textphone: 0870 240 3701

**The Houses of Parliament Shop**

12 Bridge Street, Parliament

Square, London SW1A 2JX

Telephone orders/general enquiries: 020 7219 3890

Fax orders: 020 7219 3866

Email: [shop@parliament.uk](mailto:shop@parliament.uk)

Internet: <http://www.shop.parliament.uk>

**TSO@Blackwell and other accredited agents**

**HM Treasury contacts**

This document can be found in full on our website: <http://www.hm-treasury.gov.uk>

If you require this information in another language, format or have general enquiries about HM Treasury and its work, contact:

Correspondence Team

HM Treasury

1 Horse Guards Road

London

SW1A 2HQ

Tel: 020 7270 5000

E-mail: [public.enquiries@hm-treasury.gov.uk](mailto:public.enquiries@hm-treasury.gov.uk)

ISBN 978-0-10-185452-8



9 780101 854528