



HM Treasury

Financial Services (Banking Reform) Bill

Government Amendments: Group Restructuring Powers ('Electrification')

Briefing for Peers

October 2013

Introduction

In its first report in February 2013, the Parliamentary Commission on Banking Standards (PCBS) proposed that the regulator should be given a reserve power to require full separation of retail and investment banking in the case of an individual banking group (the 'electrification' power). The Government fully accepts this recommendation and is committed to ensuring that the amendments we table reflect the PCBS's recommendation. To ensure this is the case, this note sets out the Government's understanding of the original PCBS amendment, and then sets out our current thinking in order to ensure that PCBS members' concerns have been addressed. Amendments to address the areas where the Bill, as drafted, is not currently meeting our shared objective of an effective electrification power will be tabled at Lords Committee stage.

PCBS Recommendation and Amendment

The PCBS's recommendation for an individual-firm separation power can be broken down into three components: the **trigger**, the **power**, and the **procedure**.

Trigger

The PCBS recommended that the regulator should be able to require a group to separate *'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.'*¹ The PCBS's proposed amendment (Amendment J, included in the PCBS's Second Report) rendered this as a *'significant risk that the appropriate regulator will not be able to advance the [continuity objective]'*.

¹ PCBS *First Report*, paragraph 165.

Power

In its First Report, the PCBS recommended that the regulator should have the power to require an individual banking group *'to divest itself fully of either its ring-fenced or its non-ring-fenced bank.'* The PCBS's Second Report proposed an additional power *'to require a bank to divest itself of a specified division or set of activities.'*²

The PCBS's proposed amendment gave the regulator power to require the relevant banking group to take steps

'to secure one of the following results-

(a) that there is no member of the group with a Part 4A permission to carry on a regulated activity of a description specified in the notice;

(b) that no member of the group is a ring-fenced body;

(c) that there is no member of the group with a Part 4A permission to carry on a regulated activity which is not a ring-fenced body.'

Procedure

The PCBS recommended that before the regulator could require a group to separate, it should first inform the group of its intentions, and give the group an opportunity to make representations. As a safeguard for the group, the regulator should then appoint an independent reviewer to consider the case. If in the light of the reviewer's report and any representations from the group the regulator decided to proceed, it would have to obtain the consent of HM Treasury before imposing its requirements on the group in question.³

The PCBS's proposed amendment provided for the regulator to give the banking group in question a **notice of its intention** to require separation: the notice would have to specify a period of **at least 3 months** for the group to make representations. The notice would also name an independent reviewer.

Having received the reviewer's report and any representations from the group, the regulator would then have to decide whether to require separation. If it did, the regulator would have to publish a **notice of its proposal** to require separation at least 60 days before the requirement was imposed. The **consent of the Treasury** would also have to be obtained at least 60 days before the requirement was imposed. The banking group would have a right to **appeal to the Tribunal** against the regulator's decision. The regulator would specify the date by which its requirements must be implemented.

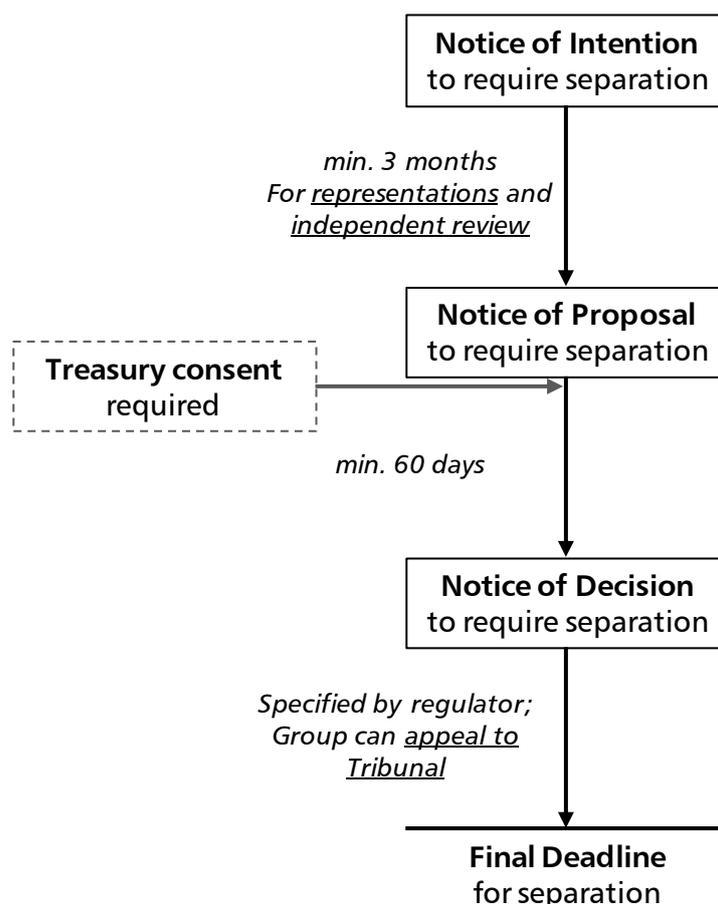
Thus under the PCBS's proposed amendment the minimum time between the regulator issuing notice of its intention and imposing a requirement to separate would be **approximately 5 months** (3 months, plus 60 days).⁴ The deadline for separation to be complete would be set by the regulator. The procedure in the PCBS's proposed amendment, and the minimum times for each stage, are summarised in Figure 1 below.

² PCBS *Second Report*, paragraph 19.

³ PCBS *First Report*, paragraphs 167-168.

⁴ On the assumption that the independent review is completed within the minimum three months.

Figure 1: PCBS amendment procedure for requiring separation and minimum times



Proposed amendments

The Government has developed amendments to the 'group restructuring powers' provisions of the Banking Reform Bill to bring the power for individual group full separation broadly into line with the PCBS's recommendation. This section sets out a) how the current Bill implements the PCBS recommendation, b) where the Bill will be amended to bring it into line and c) where there are necessary additions or adjustments to the PCBS proposal, and the rationale for these. The following sections set out the Bill provisions as we propose to amend them in terms of the **trigger**, the **power**, and the **procedure** for individual group separation.

Trigger

The Government has adopted the same trigger as the PCBS, but believes there is a need [to go further] and introduce additional triggers. The Bill currently provides that the regulator may exercise its 'group restructuring powers' if one or more of four conditions is met. Condition D in the Bill is that the conduct of a ring-fenced bank or another member of its group is having, or is likely to have, an adverse effect on the regulator's advancement of its continuity objective.⁵ This is the same as the condition proposed by the PCBS for the exercise of the individual group separation power.

Conditions A, B and C in the current Bill are additional to the PCBS's proposed trigger. These conditions identify three cases where a group's ring-fenced bank is not sufficiently independent of the rest of the group. These

⁵ Financial Services (Banking Reform) Bill, clause 4, new section 142K(5).

conditions are the obverse of the objectives set for 'ring-fencing rules' in the Bill.⁶ Conditions A, B and C thus provide for the case where a group's conduct is such that rules are unable to achieve these objectives in respect of that group, for example because a group had repeatedly been able to find creative ways to abide by the letter of the rules while still subverting their purpose, and the regulator had been unable to 'keep up' with the group's behaviour by making new rules to address the weaknesses the group had exploited.

Power

The Government's position, as currently reflected in the Bill goes beyond the power as drafted in the PCBS report, in order to allow the regulator to impose the full suite of requirements proposed by the PCBS in its *First* and *Second Reports*. The PCBS amendment made no provision for the regulator to require a group to divest itself of particular business units or sets of activities which would not involve the cessation of a regulated activity.⁷

The current Bill provisions were therefore expanded from the original PCBS provision to give the regulator the power either:

- to direct the parent company of a banking group to divest itself of specified subsidiaries (either the ring-fenced bank or any other group companies); or
- to require any regulated company within a banking group to dispose of specified assets and/or parts of its business.⁸

The Bill's provisions also specify what actions the regulator may require a banking group to undertake (i.e. the disposal of shares in group companies, or the transfer of business), which is additional to the PCBS amendment and thereby reduces the risk of a legal challenge in the event that the regulator attempted to use the powers.⁹

Procedure

The amendments that have been developed will provide for a procedure in the Bill for requiring full separation of an individual group that will be largely the same as that proposed by the PCBS. However, having consulted with the PRA, the proposed drafting currently adjusts the procedure proposed by the PCBS somewhat to bring it more closely into line with the process that is currently set out in the Financial Services and Markets Act (2000) (FSMA) for the issuing of similar notices, in particular in relation to the time between notices and the content of notices.

The first stage under the PCBS procedure was for the regulator to issue a "**notice of intention**" to the group in question, informing it of the regulator's intention to require a restructuring. The Government's original provisions

⁶ Financial Services (Banking Reform) Bill, clause 4, new section 142H(4).

⁷ The PCBS's proposed amendment would allow the regulator to require the disposal of all of a specified regulated activity (e.g. all dealing in investments as principal). But it may not allow the regulator to require more 'targeted' disposal, either of sub-sets of a regulated activity (e.g. a requirement to dispose of equities trading business but not trading in other investments), or of only some entities within a group carrying on a regulated activity (e.g. a requirement to divest a specified group company that traded in investments, but to allow trading to continue in other group entities).

⁸ Financial Services (Banking Reform) Bill, clause 4, new section 142L.

⁹ Legal challenge could be on the grounds that the legislation did not explicitly give the regulator the power to require whatever specific steps it was proposing to require, and hence that the regulator had acted *ultra vires*.

required the regulator to issue three such notices, but the Government now proposes to adjust the Bill to require just a single notice of the regulator's intention, called a **preliminary notice**. The Government agrees that the preliminary notice must state the regulator's reasons both for concluding that the conditions for the restructuring powers to be exercisable have been met, and for whatever actual restructuring the regulator proposes to require. To bring it into line with the PCBS recommendation the Government proposes to remove the requirement to seek Treasury consent at this stage (under the Government's original provisions, Treasury consent was required for both the first and second preliminary notices). Instead the Government proposes that the regulator must give a copy of the preliminary notice to HM Treasury.

Having issued a preliminary notice, the PCBS amendment proposes a three month pause for the group to make representations and for an independent review. The Government proposes that regulator must allow **at least 14 days** for the group to make representations. This is to bring it into line with the practice set out elsewhere in the Financial Services and Markets Act (2000) (FSMA) for the issuing of similar notices. That is shorter than the original PCBS proposal of three months. The Government does not propose to include provision for an independent review as any group on which the regulator imposed a requirement to restructure would have the right to appeal the decision to the Tribunal. To the extent that the electrification power is intended to protect against lobbying and 'gaming' by banks, the opportunity to forestall the process would seem contrary to the spirit of the proposal. Put simply, there is a risk that an independent review could undermine the effectiveness of the electrification power.

It may be that a group begins making changes of its own initiative in order to address the circumstances that made the regulator consider imposing a requirement to restructure. This raised the question of how the law would treat the case of a firm that, having received an initial notice from the regulator, had sought of its own accord to remedy the perceived failing and put in place measures to satisfy the regulator that that failing could not arise again. The Government considered it appropriate to provide explicitly for a period in which firms could take such action on their own initiative after having been served with a preliminary notice. Once the deadline for the firm to make representations has passed, the Government originally proposed a pause of 12 to 18 months. However, in light of the arguments made in Parliament, not least by members of the PCBS, the Government agrees that a pause of 12 to 18 months may unnecessarily extend the process, so now proposes to cut this down to a period of three to six months.

If, in the light of any representations and despite any changes made by the group, the regulator wishes to require a restructuring, the PCBS proposed the regulator must issue a "**notice of proposal**", setting out what requirements it intends to impose. The Treasury has adopted this proposal in full, but it is called a **warning notice**, as per FSMA nomenclature.

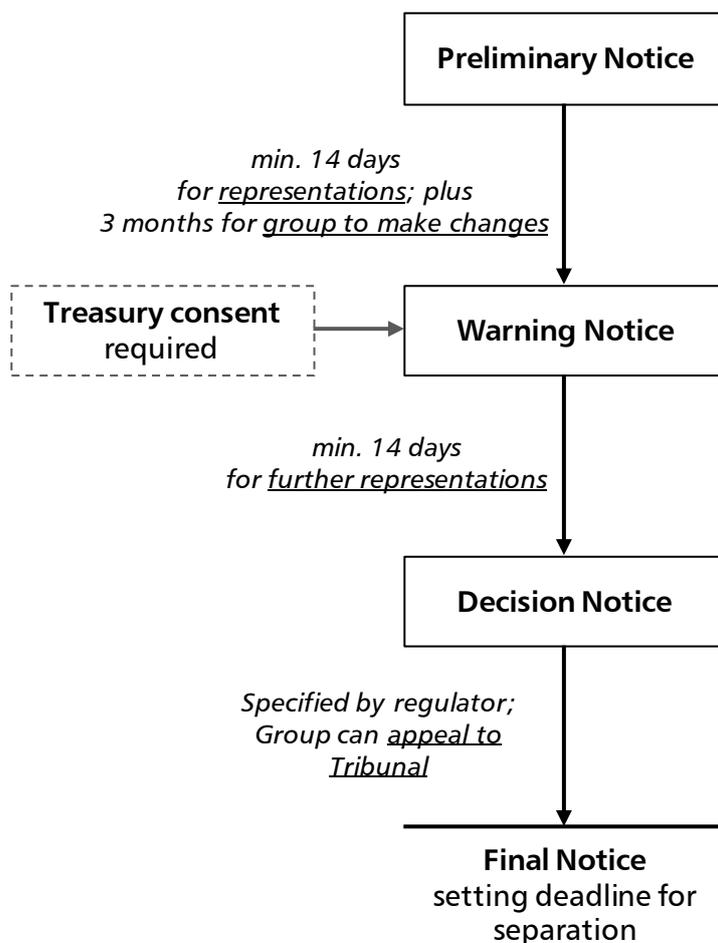
Under the PCBS proposal, this notice would be followed, no sooner than 60 days later, by a "**notice of decision**". With a view to enhancing the effectiveness of the power, a 60 day delay seems excessive in the context of delivering a "notice of decision". The Government therefore proposes instead that, in line with established practice under FSMA, having issued a warning notice, the regulator must allow **at least 14 days** for the group to make any further representations. If, in the light of any further representations, the regulator wishes to proceed, it would then issue the "notice of decision", (**decision notice** as per FSMA), requiring the group to restructure. The group would then have a right to **appeal to the Tribunal** against the regulator's decision. This is the established protection for firms under FSMA against arbitrary behaviour by the regulator.

Once any appeal against the regulator's decision had been dismissed (or once the period for the group to appeal has passed without it having done so), under FSMA the regulator would issue a **final notice** specifying the

deadline for any restructuring to be complete. In line with the PCBS proposal, the Government proposes to amend the current Bill to give the regulator discretion over the final deadline for restructuring to be complete (the Government's original provisions specified that the deadline set by the regulator could not be sooner than 5 years from the date of the decision notice).

Thus under the Government's revised process, the minimum time between the regulator issuing a preliminary notice and a decision notice would be **approximately 4 months** (14 days, plus 3 months, plus 14 days). The deadline for separation to be complete would be set by the regulator. The proposed procedure following the Government's proposed amendment, and the minimum times for each stage, are summarised in Figure 2 below.

Figure 2: Government amended procedure for requiring restructuring and minimum times



Publication of Notices

The PCBS proposed the publication of both the regulator's proposal to require a group to separate, and the Treasury decision on whether or not to consent to that proposal. Once a requirement to restructure has been imposed in a final notice, stock exchange listing rules would require the group to disclose this information, but market sensitivity concerns would potentially impact negatively on the group's viability should that information be made public any earlier. This is a significant risk given that the Treasury could still not give consent, the bank itself could take sufficient action to address the regulator's misgivings or the regulator itself may decide not to proceed.

Having consulted the regulator, the proposed position in the attached draft is consistent with the general principles in FSMA governing the publication of warning notices, decision notices and final notices.

Annex A: Financial Services (Banking Reform) Bill provisions for Group Restructuring Powers following Government amendments

Group restructuring powers

142K Cases in which group restructuring powers become exercisable

- (1) The appropriate regulator may exercise the group restructuring powers only if it is satisfied that one or more of Conditions A to D is met in relation to a ring-fenced body that is a member of a group.
- (2) Condition A is that the carrying on of core activities by the ring-fenced body is being adversely affected by the acts or omissions of other members of its group.
- (3) Condition B is that in carrying on its business the ring-fenced body—
 - (a) is unable to take decisions independently of other members of its group, or
 - (b) depends on resources which are provided by a member of its group and which would cease to be available in the event of the insolvency of the other member.
- (4) Condition C is that in the event of the insolvency of one or more other members of its group the ring-fenced body would be unable to continue to carry on the core activities carried on by it.
- (5) Condition D is that the ring-fenced body or another member of its group has engaged, or is engaged, in conduct which is having, or would apart from this section be likely to have, an adverse effect on the advancement by the appropriate regulator—
 - (a) in the case of the PRA, of the objective in section 2B(3)(c), or
 - (b) in the case of the FCA, of the continuity objective.
- (6) The appropriate regulator may not exercise the group restructuring powers in relation to any person if—
 - (a) either regulator has previously exercised the group restructuring powers in relation to that person, and
 - (b) the decision notice in relation to the current exercise is given before the second anniversary of the day on which the decision notice in relation to the previous exercise was given.
- (7) In this section and sections 142L to 142Q “the appropriate regulator” means—
 - (a) where the ring-fenced body is a PRA-authorized person, the PRA;
 - (b) where it is not, the FCA.

142L Group restructuring powers

- (1) In this Part “the group restructuring powers” means one or more of the powers conferred by this section.
- (2) Where the appropriate regulator is the PRA, the powers conferred by this section are as follows—
 - (a) in relation to the ring-fenced body, power to impose a requirement on the ring-fenced body requiring it to take any of the steps mentioned in subsection (5),
 - (b) in relation to any member of the ring-fenced body’s group which is a PRA-authorized person, power to impose a requirement on the PRA-authorized person requiring it to take any of the steps mentioned in subsection (6),
 - (c) in relation to any member of the ring-fenced body’s group which is an authorized person but not a PRA-authorized person, power to direct the FCA to impose a requirement on the authorized person requiring it to take any of the steps mentioned in subsection (6), and
 - (d) in relation to a qualifying parent undertaking, power to give a direction under this paragraph to the parent undertaking requiring it to take any of the steps mentioned in subsection (6).
- (3) Where the appropriate regulator is the FCA, the powers conferred by this section are as follows—
 - (a) in relation to the ring-fenced body, power to impose a requirement on the ring-fenced body requiring it to take any of the steps mentioned in subsection (5),

- (b) in relation to any member of the ring-fenced body's group which is an authorised person but not a PRA-authorised person, power to impose a requirement on the authorised person requiring it to take any of the steps mentioned in subsection (6),
 - (c) in relation to any member of the ring-fenced body's group which is a PRA-authorised person, power to direct the PRA to impose a requirement on the authorised person requiring it to take any of the steps mentioned in subsection (6), and
 - (d) in relation to a qualifying parent undertaking, power to give a direction under this paragraph to the parent undertaking requiring it to take any of the steps mentioned in subsection (6).
- (4) A parent undertaking of a ring-fenced body by reference to which the group restructuring powers are exercisable is for the purposes of this Part a "qualifying parent undertaking" if —
- (a) it is a body corporate which is incorporated in the United Kingdom and has a place of business in the United Kingdom, and
 - (b) it is not itself an authorised person.
- (5) The steps that the ring-fenced body may be required to take are—
- (a) to dispose of specified property or rights to an outside person;
 - (b) to apply to the court under Part 7 for an order sanctioning a ring-fencing transfer scheme relating to the transfer of the whole or part of the business of the ring-fenced body to an outside person;
 - (c) otherwise to make arrangements discharging the ring-fenced body from specified liabilities.
- (6) The steps that another authorised person or a qualifying parent undertaking may be required to take are—
- (a) to dispose of any shares in, or securities of, the ring-fenced body to an outside person;
 - (b) to dispose of any interest in any other body corporate that is a member of the ring-fenced body's group to an outside person;
 - (c) to dispose of other specified property or rights to an outside person;
 - (d) to apply to the court under Part 7 for an order sanctioning a ring-fencing transfer scheme relating to the transfer of the whole or part of the business of the authorised person or qualifying parent undertaking to an outside person.
- (7) In subsections (5) and (6) "outside person" means a person who, after the implementation of the disposal or scheme in question, will not be a member of the group of the ring-fenced body by reference to which the powers are exercised (whether or not that body is to remain a ring-fenced body after the implementation of the disposal or scheme in question).
- (8) It is immaterial whether a requirement to be imposed on an authorised person by the appropriate regulator, or by the other regulator at the direction of the appropriate regulator, is one that the regulator imposing it could impose under section 55L or 55M.

142 M Procedure: preliminary notices

- (1) If the appropriate regulator proposes to exercise the group restructuring powers in relation to any authorised person or qualifying parent undertaking ("the person concerned"), the regulator must give each of the relevant persons a ~~first preliminary notice stating —~~
- ~~(a) that the regulator is of the opinion that the group ring-fencing powers have become exercisable in relation to the person concerned, and~~
 - ~~(b) its reasons for being satisfied as to the matters mentioned in section 142K(1).~~
- notice (a "preliminary notice").**
- (1A) **The preliminary notice must—**
- (a) state that it is a preliminary notice,**
 - (b) state that the regulator proposes to exercise the group restructuring powers,**
 - (c) state the action which the regulator proposes to take in the exercise of those powers,**

- (d) **be in writing, and**
 - (e) **give reasons for the proposed action (which must include the regulator’s reasons for being satisfied as to the matters mentioned in section 142K(1)).**
- ~~(2) Before giving a first preliminary notice, the regulator must —~~
- ~~(a) give the Treasury a draft of the notice,~~
 - ~~(b) provide the Treasury with any information that the Treasury may require in order to decide whether to give their consent, and~~
 - ~~(c) obtain the consent of the Treasury.~~
- (2) The appropriate regulator must give a copy of the preliminary notice to the Treasury.**
- (3) The ~~first~~ preliminary notice must specify a reasonable period (which may not be less than 14 days) within which any of the relevant persons may make representations to the regulator.
- (4) The relevant persons are—
- (a) the person concerned,
 - (b) the ring-fenced body, if not the person concerned, and
 - (c) any other authorised person who will, in the opinion of the appropriate regulator, be significantly affected by the exercise of the group restructuring powers.
- ~~(5) After considering any representations made by any of the relevant persons, the regulator must either —~~
- ~~(a) with the consent of the Treasury, give each of the persons a second preliminary notice, or~~
 - ~~(b) give each of them a notice stating that it has decided not to exercise its group restructuring powers.~~
- ~~(6) A second preliminary notice is a notice stating —~~
- ~~(a) that the regulator proposes to exercise the group restructuring powers, and~~
 - ~~(b) the manner in which it proposes to do so.~~
- ~~(7) The second preliminary notice must specify a reasonable period (which may not be less than 14 days) within which any of the relevant persons may make representations to the regulator about the proposals.~~
- ~~(8) The regulator must after considering any representations made in response to the second preliminary notice give each of the relevant persons a third preliminary notice stating —~~
- ~~(a) whether it has made any revisions to the proposals, and~~
 - ~~(b) if so, what the revisions are.~~

142N Procedure: warning notice and decision notice

- (1) If the appropriate regulator has given a ~~third preliminary notice~~ **preliminary notice under section 142M**, it must either—
- (a) if, **having considered any representations made by any of the relevant persons**, it still proposes to exercise the group restructuring powers, give each of the relevant persons a warning notice during the warning notice period, or
 - (b) before the end of the warning notice period, give each of them a **written** notice stating that it has decided not to exercise the powers **and give a copy of that notice to the Treasury.**
- (2) The “warning notice period” is the period of ~~6 months beginning with the first anniversary of the day on which the third preliminary notice was given.~~
- (a) **beginning 3 months after the end of the period specified under section 142M(3) as that within which any representations must be made, and**
 - (b) **ending 6 months after the end of that period.**
- (3) Before giving a warning notice under subsection (1)(a), the appropriate regulator must —
- (a) give the Treasury a draft of the notice,

- (b) provide the Treasury with any information that the Treasury may require in order to decide whether to give their consent, and
 - (c) obtain the consent of the Treasury.
- (4) The action specified in the warning notice may be different from that specified in the ~~third~~ preliminary notice if—
- (a) the appropriate regulator considers that different action is appropriate as a result of any change in circumstances since the ~~third~~ preliminary notice was given, or
 - (b) the person concerned consents to the change.
- (5) The regulator must, in particular, have regard to anything that—
- (a) has been done by the person concerned since the giving of the ~~third~~ preliminary notice, and
 - (b) represents action that would have been required in pursuance of the proposals in that notice.
- (6) If the regulator decides to exercise the group restructuring powers it must give each of the relevant persons a decision notice.
- (7) The decision notice must ~~allow at least 5 years from the date of the decision notice for the completion of—~~
specify the date or dates by which each of the following must be completed—
- (a) any disposal of shares, securities or other property that is required by the notice, ~~or~~
 - (b) any transfer of liabilities for which the notice requires arrangements to be made.
- (8) The giving of consent for the purpose of subsection (4)(b) does not affect any right to refer to the Tribunal the matter to which any decision notice resulting from the warning notice relates.
- (9) “The relevant persons” has the same meaning as in section 142M.

Sections 142O to 142V remain as in the Bill at introduction to the House of Lords.