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Banking reform:

delivering stability and supporting a sustainable economy

Cm 8356

June 2012

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delivering stability and supporting a sustainable economy

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

June 2012

Cm 8356 £21.25

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

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

ISBN: 9780101835626
PU1321

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

ID P002495175 06/12

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Foreword

The worst crisis in a generation exposed a great many flaws in the financial system. Banks ran risks that they did not understand. Investors did not put sufficient pressure on institutions to manage risk effectively and bought securities that proved to be far from secure. Management oversaw banks that were too complex and intermingled. Non-banks and the shadow banking sector became intertwined in complex ways with the banking system. Regulators, central banks and politicians were not sufficiently robust in supervising firms, nor were they equipped with effective resolution tools to resolve banks without resorting to huge amounts of capital injections. European taxpayers have provided billions in capital to their banks, and trillions in liquidity support. In short, the crisis, as well as causing a global recession, exposed a range of problems which required action, most crucial of which is the perceived implicit guarantee enjoyed by banks and other financial firms.

A wide range of issues means a wide range of solutions is necessary. Internationally, the UK has led the way in shaping European legislation to reform the regulation of insurers, derivatives trading and better capital and liquidity standards for banks. Domestically we are overhauling the regulatory architecture, ensuring that the new authorities have the tools they need to deliver effective macroprudential regulation, and have taken steps on excessive remuneration in the banking sector. Good progress has been made, though there remains more to do, notably in resolution of non-banks and investment banks, and promoting effective competition in banking.

Banking reform is therefore one – albeit fundamental – part of the work the Government is taking forward to create a safe and stable UK banking sector. Sir John Vickers and the Independent Commission on Banking (ICB) provided compelling recommendations for creating a stronger and more competitive banking sector and maintaining Britain's place as home to world-leading banks, without exposing British taxpayers to the unacceptable costs of those banks failing in a disorderly manner.

The financial services sector is an important part of the UK economy, employing around 1.4 million people and, in 2010/11, contributing £63bn in tax. The UK will continue to be a leader in the global economy of the future – this year in the UK, the first Renminbi bond was issued outside Chinese sovereign territory.

In the same way that action we have taken has meant that UK debt is currently seen as a safe haven asset by investors around the world, we will ensure that British banks will be resilient, stable and competitive, and so attractive to investors, depositors and borrowers everywhere. This will enhance the UK's reputation as the world's leading financial centre.

This white paper sets out the Coalition Government's proposals for implementation. The aims of these reforms are clear. First, since future financial crises rarely repeat the pattern of the past, we must focus on making banks more resilient to shocks. Second, we must make our banks more resolvable so that, should they fail, it is in a manner that does not threaten the provision of vital services essential to the real economy. Seeing through these aims will curb excessive risk taking in financial markets – it must be clear that creditors reap rewards when banks do well, but take the pain if banks fail. These reforms are a vital step forwards in creating the right environment for competition in banking to flourish. Reducing the perceived implicit guarantee which predominantly benefits the larger systemic banks will encourage greater competition as well as enhance financial stability, ensuring wider lending to consumers and SMEs.

The Government will implement the ICB's recommendations in line with these important objectives. The continuing financial instability in the Eurozone only bolsters the case for reform. Domestic, European and international regulatory developments support adjustments that make implementation of the reforms more practicable. The Government is conscious of the need to balance stability with the economic recovery.

A robust ring fence, separating investment banking and related activities from more traditional personal and business lending, is vital to reduce structural complexity and to make banks easier to resolve in crisis, where speed of execution is vital. Ring-fenced banks must be genuinely independent from other parts of the group. The ring-fenced bank should not carry out any activities through non-EEA subsidiaries or branches. A separate risk committee should be set up in the ring-fenced bank, whose risk management function should introduce additional safeguards, over and above what the ICB recommended. But, in order to provide the UK's SMEs with essential banking services, ring-fenced banks should be able to offer simple hedging products, subject to the necessary safeguards. Recent EU and international reforms to derivatives mitigate the risk that these derivatives pose a barrier to resolution. The Government is committed to legislating to require banks to implement the ring-fence in this Parliament.

To be more resilient and resolvable, banks need to hold sufficient capacity to absorb losses. Building on the international consensus for higher levels of bank capital, banks providing vital services to the UK economy must hold extra equity to withstand shocks. The UK's globally systemic and ring-fenced banks will also need to hold more loss absorbing debt. The Government believes that a primary loss absorbing capacity of 17 per cent of risk-weighted assets is broadly the appropriate level for UK banks. Their overseas operations will be exempt if they are resolvable without risk to UK taxpayers, but additional loss absorbing capacity may be required of firms if resolvability concerns persist. To ensure losses fall on those most able to assess bank risks, the Government will introduce a credible and effective bail-in tool, already endorsed by the G20 and the Financial Stability Board, through a European resolution framework. Insured depositors will be preferred, as the ICB recommended. There should be a binding leverage ratio, but the Government does not see a case for increasing beyond the Basel III level, currently proposed at 3 per cent. These measures strike the right balance to ensure that UK banks are robust at all times and that they can play their part in stimulating economic growth in the UK.

The Government reiterates its strong support for a more competitive UK banking sector. The emergence of a strong challenger bank from the Lloyds Banking Group divestment is important. To further stimulate the ability of new entrants to compete on a level playing field, the Bank of England and Financial Services Authority are conducting reviews of prudential and conduct requirements to ensure that these are proportionate and do not pose excessive barriers to entry for prospective new entrants. The Government remains committed to ensuring that the new, industry-funded switching service is operational by September 2013, and that transparency of products for consumers is enhanced. The Government will shortly issue a consultation on a number of options to reform the strategy setting of payments, to ensure that UK payments systems meet the current and future needs of consumers, businesses, other users and the wider economy.

A zero-failure financial system is not our aim, nor should it be. We want a dynamic financial system that is stable over time with the perceived implicit guarantee reduced by ensuring that the underlying riskiness of banks is more accurately reflected through the true price of their debt.

The reforms proposed here will ensure that we meet the challenge of the British Dilemma, namely how to remain a successful global financial centre without asking taxpayers to bear unacceptable risks. We remain committed to ensuring that the UK's banks are sufficiently resilient to withstand excessive financial shocks, and sufficiently resolvable so as to fail safely without drawing on taxpayer support. In doing so, banks will be better placed to meet their core purpose – lending to the real economy so as to contribute to balanced and sustainable growth.

George Osborne

Chancellor of the Exchequer

Chair of Cabinet Committee on Banking Reform

Vince Cable

Secretary of State, Department for Business, Innovation and Skills

Deputy Chair of Cabinet Committee on Banking Reform

1 Context of these reforms

1.1 The worst financial crisis in several generations has caused unprecedented disruption in banking systems and markets around the world. It has exposed many problems within the global financial system and in the way it was regulated and governed.

1.2 Risk was distributed across the financial system and held by institutions that did not fully understand the degree to which they were exposed to such risks. Banks, some with operations spread across the globe, had become too large and too complex.

1.3 Authorities did not accurately identify the degree of risk in the system nor did they have the tools to deal with institutions in serious difficulty. European taxpayers contributed €288bn in bank recapitalisations between October 2008 and December 2010,[1] and are still being called upon to provide support, such as recent injections into the Franco-Belgian bank Dexia and Spanish bank Bankia. This degree of taxpayer support has had significant negative impacts on the European single market.

1.4 The UK has shown leadership in European and global fora in addressing the challenges of the financial crisis, from shaping the vital Basel III reforms, to leading development of the Financial Stability Board's (FSB) *Key Attributes of Effective Resolution Regimes*, and working with our European partners to implement the G20 commitments on derivatives trading, credit rating agencies and banks' prudential standards. At home, the Government has brought forward major reforms of the regulatory framework to replace the failed system of the past. The proposals put forward in this white paper are part of a broader programme of reform.

1.5 The IMF has stated that UK financial stability is a global public good.[2] The UK financial sector is a major part of the UK's economy, supporting around 1.4 million jobs nationwide and contributing £63bn in tax in 2010/11.[3] The deep and wide markets and open competition that make the UK the leading European and international centre for financial services[4] must be enhanced through the reforms necessary to secure this country's future stability and competitiveness. These reforms also make a direct contribution to strengthening the European single market by reducing perceived implicit taxpayer guarantees which distort the level playing field in the European Union.

The proposals in this paper

1.6 This white paper sets out the Coalition Government's proposals for taking forward implementation of the recommendations of the Independent Commission on Banking (ICB), chaired by Sir John Vickers. The ICB recommended a package of measures, consisting of ring-fencing vital banking services, increasing banks' loss-absorbency and enhancing competition in the banking sector. The Government remains strongly committed to implementing these proposals. The Government's view is that all banks should be subject to normal competitive

[1] Commission Services, Facts and figures on state aid in the EU Member States, Commission Staff Working Document, SEC (2011)1487, December 2011.

[2] *United Kingdom Spillover Report for the 2011 Article IV Consultation and Supplementary Information*, IMF, July 2011. Available at: http://www.imf.org/external/pubs/ft/scr/2011/cr11225.pdf

[3] *Interim Report*, Independent Commission on Banking, April 2011; PwC, *The Total Tax Contribution of UK Financial Services* December 2011.

[4] *Global Financial Centres Index 11*, Z/Yen and Qatar Financial Centre Authority, March 2012.

market forces, which means they must be able to fail safely without relying on a government guarantee and without putting the provision of critical services at risk.

1.7 This paper aims to give clarity as to how the Government will implement these proposals, but recognises that the final, detailed shape of these proposals will be developed over a period of time. The technical nature of some elements of the reforms will require secondary legislation and/or rules made by the regulator. In such cases, there will of course be full consultation. The Government also welcomes the recent publication of the European Commission proposal for a Recovery and Resolution Directive (RRD)[5] that will enhance the resolution tool kit at the disposal of Member States' resolution authorities, and facilitate the resolution of EU cross-border banks.

1.8 This chapter sets out the wider domestic and international context and outlines the next steps in implementation of the ICB reforms. Chapter 2 sets out the Government's proposal to ring-fence vital banking services from wholesale and investment banking activities. Chapter 3 sets out measures on capital, loss-absorbing debt, a bail-in mechanism, a leverage ratio, and depositor preference that collectively make up the loss-absorbency proposals. Chapter 4 considers proposals on competition in the banking sector.

The wider context

1.9 Banks must be resilient and resolvable, but this is not an end in itself. Rather, it is the means by which banks can undertake their core functions: the management of risk, taking deposits, the provision of payments services to firms and households, and the efficient allocation of credit to the real economy. The measures outlined in this paper will ensure UK banks are more robust at all times, while allowing them to compete and play their part in stimulating UK economic growth. Though financial stability is a prerequisite for growth, the proposals are calibrated to ensure that the financial stability benefits of the reforms are not introduced at the expense of the economic recovery. Since the publication of the ICB's final report in September 2011, there have been developments in European legislation, domestic reforms and the market conditions, which the proposals in this paper reflect.

1.10 By adopting these measures, alongside other reforms in train, the Government will create a safe and stable UK banking sector in the longer term that is resilient to both systemic and idiosyncratic shocks. These measures will strengthen the universal banking model. In the same way that action the Government has taken has meant that UK debt is currently seen as a safe haven asset by investors around the world, these reforms will ensure that British banks will be resilient, stable and competitive, and so attractive to investors, depositors and borrowers everywhere. Thereby, the UK's reputation as the world's leading financial centre will be further enhanced.

1.11 The UK, and all G20 and EU countries, have committed to reduce the perceived implicit guarantees to their banking sectors. The assumption that governments will step in to bail out banks reduces the risk premium for bank debt as creditors do not believe they will be exposed to the risks associated with their investment. This leads to undesirable consequences:

- as the costs of bank failure fall on government, not bank creditors, the costs are seen as a contingent liability of the state, and therefore increase the risk premia on sovereign debt;
- as large, systemically important banks are perceived to be the beneficiaries of an implicit state guarantee their borrowing costs are reduced, giving them a significant

[5] Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010, European Commission, June 2012. http://ec.europa.eu/internal_market/bank/docs/crisis-management/2012_eu_framework/COM_2012_280_en.pdf

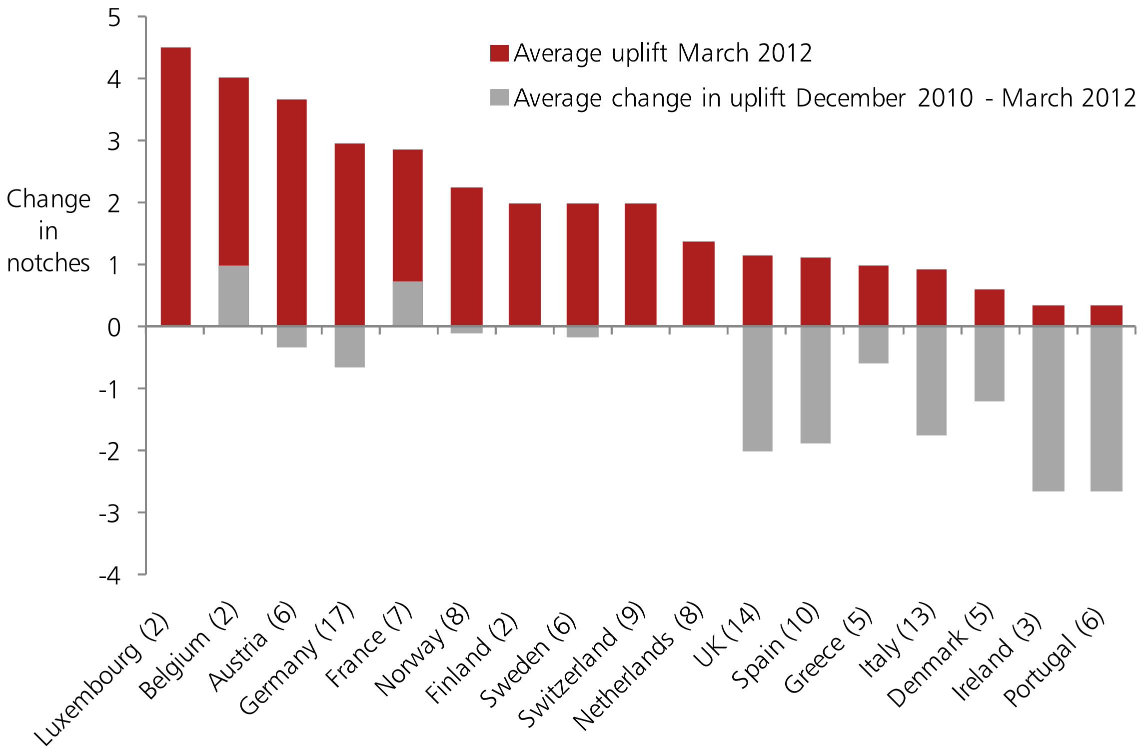
competitive advantage over banks that are deemed small enough to fail without systemic impacts; and

- the perception of an implicit guarantee leads to an inefficient allocation of capital across the economy as a whole. Investments made on the assumption of an implicit guarantee do not reflect investors' true risk appetite which leads to capital accumulating disproportionately in some areas of the economy. They represent a major distortion to the European single market.

1.12 While the size of the perceived implicit guarantee is debated, and varies over time, there is wide agreement that it remains substantial across the European Union. A number of analyses have attempted to assess how individual firms benefit from the perception of government support by comparing their 'standalone' credit ratings (which do not factor in the likelihood of government support for a firm) to their 'uplifted' credit ratings (which do).

1.13 The OECD compares credit ratings of financial institutions across Europe.[6] The report shows that the 'uplift from external support' varies from country to country depending on their propensity and ability to provide support. Though this may be in part due to differences in interest rates, the OECD's findings (Chart 1.A) illustrate how widespread the perceived implicit guarantee is and shows that UK has made considerable progress in reducing it with regard to UK banks, while in other countries the perceived implicit guarantee has actually risen during this period.[7]

Chart 1.A: The perceived implicit guarantee in Europe



Source: OECD

[6] 'Implicit guarantees for bank debt: Where do we stand?', Sebastian Schich and Sofia Lindh, in: *OECD Financial Market Trends*, Vol. 2012/1, June 2012, available at: http://www.oecd.org/dataoecd/16/25/50586138.pdf

[7] However, the RRD proposals by the European Commission are also aimed at reducing the perceived implicit guarantee across the EU, and its value can be expected to decline rapidly when the RRD is implemented.

Box 1.A: Structural reform in the UK and elsewhere

Ring-fencing prohibits banks that accept retail deposits from undertaking a range of activities that are not directly connected to providing payment services and making loans. The 'Volcker Rule' – in the process of being implemented in the United States – does something similar, but is less restrictive. Its focus is on constraining the ability of banks to undertake proprietary trading. This raises the question of why ring-fencing, rather than the narrower Volcker Rule, is appropriate for the UK.

The first point to note is that ring-fencing and the Volcker Rule will both act to curtail the perceived implicit government guarantee. The Volcker Rule prevents deposits – insured in the US by the Federal Deposit Insurance Corporation (FDIC) – from being applied to proprietary trading activities from which no bank customer benefits. And the envisaged limitations on activities that can be undertaken in the ring-fenced bank would similarly prevent it from engaging in proprietary trading. Consequently, the Volcker Rule and ring-fencing are not inconsistent.

However, ring-fencing delivers additional benefits to the Volcker Rule. Most of a bank's global wholesale and investment banking operations, and the risks they entail, would be separated from everyday retail banking. This – and limits on the extent to which a ring-fenced bank can deal with other entities in its wider banking group, and other financial institutions – insulates the ring-fenced bank, and makes it more resolvable in the event it runs into trouble.

In addition, the regulatory context is different in the United States from that in the UK (and the rest of Europe). In particular:

- the United States has long had a degree of structural separation within banking groups, which prevents commercial banks from carrying out certain activities which can only be undertaken by separate, non-bank affiliates;[8]
- the banking sector in the United States is far smaller, relative to its economy, than that of the UK and other significant European economies. Aggregate assets for US banks are less than 100 per cent of GDP[9] – compared to over 300 per cent for France and Germany and around 500 per cent for the UK and Switzerland;[10] and
- there are other reforms in train in the United States aimed at limiting systemic risk from bank failure.

There is now a debate underway in the EU on the merits of structural reforms, with an Expert Group led by Governor Liikanen from the Bank of Finland. While countries like the UK and France have quite similar banking models with strong reliance on universal banking, other countries in the EU have different systems. The Expert Group will consider evidence from across the EU.

Further reform remains necessary

1.14 The Government is aware that the proposals here do not solve all the problems in the financial sector and that, in particular, there is more to be done to address the problems of resolving entities that principally conduct investment banking activities. This applies whether

[8] In addition, Section 23A of the Federal Reserve Act (enacted in 1933) imposes limitations on certain extensions of credit and other transactions between a commercial bank and its affiliates.

[9] Data are for total assets of all monetary financial institutions excluding central authorities, reported by national central banks.

[10] On 1 March 2012 a package of reforms came into force in Switzerland which – among other things – requires the biggest banks to build up a ratio of loss-absorbing capacity (capital plus contingent capital instruments) of up to 19 per cent of risk-weighted assets (RWAs).

such entities have a banking licence (as part of a universal banking group, or otherwise), or are more lightly-regulated securities firms.[11] All institutions require robust and rigorous supervision.

Investment firm and non-bank resolution

1.15 Ring-fencing is designed to improve the resilience and resolvability of UK banks, so ensuring that even if a bank runs into trouble the provision of vital banking activities will not be interrupted. But by reducing structural complexity within universal banks, ring-fencing will strengthen universal banks and also improve the resolvability of investment firms. It does this by making an investment firm that is located within a large banking group more readily separable from banking entities in that group that conduct vital activities (in particular, retail deposit-taking).

1.16 Improving the resolvability of investment firms is a crucial step in protecting the UK's financial stability. However, ring-fencing alone does not fully address the difficulty of resolving whole banking groups (including investment firms within such groups), nor investment firms that operate outside banks. Comprehensive resolution regimes are required for investment firms and financial holding companies as well as all non-bank institutions that have the potential to be systemic.[12]

1.17 The UK has committed, along with the other G20 and EU countries, to implement the FSB's *Key Attributes for Effective Resolution Regimes*. These require the introduction of resolution regimes for financial institutions and infrastructures – of any type, so including investment firms and financial holding companies but also potentially other types of financial institutions – which have the potential for having a systemic impact on failure. These regimes – like the existing Special Resolution Regime (SRR) for deposit-taking banks – would enable the resolution of financial institutions without severe systemic disruption and whilst protecting taxpayers.

1.18 Accordingly, the Government is actively supporting work at an international level being led by the FSB and the European Commission to design and implement such regimes. On this basis the Government welcomes the inclusion of recovery and resolution regimes for investment firms and financial holding companies in the recent proposal by the European Commission for a RRD. The draft RRD would provide the Bank of England, as the resolution authority, with a range of resolution powers for investment firms and financial holding companies similar to those currently available for deposit-taking banks under the SRR.

1.19 The Government will continue to support these international efforts to address the challenge of reducing the risk to financial stability posed by some of the largest and most complex multinational non-bank financial institutions. But the Government is also committed to continuing to act – when necessary – at a domestic level, building on the reforms in this paper, to reduce the risk arising from the failure of systemic non-banks. The Government will explore the case for addressing gaps in the resolution regime framework for non-banks through domestic legislation on a more accelerated timetable than currently envisaged in the European process.

Implementation

1.20 The Government will introduce all necessary legislation as soon as Parliamentary time allows, and remains committed to completing all primary and secondary legislation by the end of this Parliament in May 2015. Banks must comply with all of the measures proposed here by 2019, as the ICB recommended.

1.21 Most of the measures proposed in this white paper do not require additional primary legislation. The competition duty for the Financial Conduct Authority (FCA) is included in the

[11] These two types are referred to in this paper collectively as 'investment firms'.

[12] The UK already has a Special Administration Regime (SAR) for investment firms. But this focuses on ensuring that on the failure of an investment firm, clients have their assets returned to them quickly; it does not provide the authorities with a comprehensive set of resolution tools for investment firms. The Government will complete a review of the SAR by early next year.

Financial Services Bill, which is currently in Parliament. Ring-fencing, depositor preference, and the application of primary loss absorbing capacity will all require primary legislation. The Government will offer a draft Bill for pre-legislative scrutiny in the autumn, and – subject to this consultation – make provisions for these measures. With the exception of depositor preference, these provisions will be predominantly enabling in nature, giving HM Treasury and/or the relevant regulators duties or powers to put in place the necessary rules and regulations.

1.22 An enabling Bill, providing powers for the detailed policy to be implemented in secondary legislation and/or rules, is appropriate given the technical nature of some of the provisions and the dynamic nature of financial institutions and markets. The balance between legislation (primary or secondary) and rules made by the regulator will be based on the nature of the particular proposal. Decisions with a socio-economic impact (such as which services to mandate and which to prohibit in the ring-fence) are rightly of concern for government which is directly accountable to Parliament. Questions of a more technical nature should be left to the regulator.

1.23 The Financial Services Bill confers on the regulators for the first time substantive powers in relation to certain unregulated parent undertakings of authorised persons. These provisions extend and strengthen the regulatory framework, enabling the regulator to apply a power of direction to parent undertakings (in prescribed circumstances) and to make rules on parent undertakings requiring the regular provision of information.

1.24 The IMF has argued that the UK should give the regulator greater authority over unregulated parent undertakings than currently envisaged in the Financial Services Bill. Further, the ICB proposals will have an impact on banking group structures and may impose greater requirements on the parent undertakings of authorised persons or other unregulated entities.

1.25 The Government will consider the merits of providing for additional regulatory powers over unregulated parent undertakings for the purposes of delivering the proposals set out in this white paper.

1.26 Some measures in this paper will require implementation in coordination with European legislation. The Government will continue to work with Member States to ensure that the UK is able to implement the proposals in this document – which support further competition in the single market – in full. The Government will continue to take into account international developments and the competitiveness of the UK industry.

How to respond

1.27 The Government seeks views on the proposals in this white paper.

1.28 Responses are requested by 6 September 2012. The Government cannot guarantee that responses received after this date will be considered.

1.29 This white paper is available electronically at: www.hm-treasury.gov.uk. You may make copies of this document without seeking permission. Printed copies of the document can be ordered on request from the address below.

Responses can be sent by e-mail to: banking.commission@hmtreasury.gsi.gov.uk.

Alternatively, they can be posted to:

Banking Reform Bill Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

1.30 When responding, please state whether you are doing so as an individual or representing the views of an organisation. If you are responding on behalf of an organisation, please make clear who the organisation represents and, where applicable, how the views of members were assembled. If you have concerns about the way in which this document is being managed or conducted, please contact:

Tom Eland
Transport Regulation and Competition
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

2 Ring-fencing

2.1 This chapter sets out the Government's proposals for the 'ring-fencing' of critical banking services whose temporary interruption would have a significant direct impact on the domestic economy, in particular on households and small and medium-sized enterprises (SMEs). It begins with a discussion of the 'location' of the ring-fence – in other words, the designation of which services should be in and which should be out. Following that is a discussion of the 'height' of the ring-fence – delineating the relationship between the ring-fenced entity and the rest of the banking group in which it sits. A discussion on the scope of the proposals – the application of ring-fencing requirements to small banks and building societies – completes this chapter.

Policy objective

2.2 The aim of this policy is to:

- insulate critical banking services from shocks elsewhere in the financial system; and
- make it easier to preserve the continuity of those services, while resolving financial institutions in an orderly manner and without injecting taxpayer funds.

2.3 This structural reform will preserve many of the benefits of modern banking, but will substantially reduce the perceived implicit guarantee that derives from the presumption that government will be compelled to step in to support failing banks.

Approach to regulation

2.4 The Government proposes to bring forward primary legislation which will define the objective of the ring-fence, its main elements, and set out a number of powers for the Government to make further provision in relation to the ring-fence in secondary legislation. It will also define technical matters where the regulator will need to make provision in rules to preserve the ring-fence.

The scope of mandated services[1]

2.5 The Government proposes to provide in primary legislation that mandated services may only be provided in ring-fenced banks.[2] The Government proposes that the only activity which initially should be mandated in primary legislation is accepting deposits. The Government will take a power to provide for exceptions in secondary legislation, which will be used to ensure that the mandated activity is limited to deposits from individuals and SMEs. In consequence it will be possible only for ring-fenced banks to provide overdrafts to these depositors.

2.6 This approach will deliver significant flexibility for banking customers while enhancing the safety of critical banking services. For example, while not mandated, larger corporates will

[1] As a strict matter of law 'mandated services' might more accurately be described as 'protected services' as the policy is not intended to impose an obligation on any authorised person to provide these services if they do not wish to, but rather, where such services are provided, to impose constraints or protections that govern how those services can be provided. Legislation for ring-fencing will likely use different terms; for the sake of clarity the terminology used by the ICB is repeated here.

[2] A ring-fenced bank for these purposes will be a person with permission to accept deposits who complies with the requirements set out in this white paper.

continue to be able to use ring-fenced banks or parts of a banking group to source loans or provide clearing and payments services, depending on pricing or their risk appetite. Individuals and SMEs will be able to access a range of investment services, either directly from non-ring-fenced banks, or indirectly through their ring-fenced bank acting as an agent of a third party.

2.7 The Government proposes to take a power to make secondary legislation to define additional mandated activities, which must therefore only be undertaken by ring-fenced banks.[3] At this stage, however, the Government does not propose to require that further activities be undertaken only by ring-fenced banks. The Government's expectation is that where banks carry out other functions important to the domestic economy, such as the provision of domestic credit to households and SMEs and payment and transaction services, these will as a matter of practice be undertaken by their ring-fenced entities. However, the Government will continue to consider this matter. The Government would consider requiring additional activities to be undertaken by ring-fenced banks where:

- a short-term interruption of provision would have a significant impact on UK households and SMEs; and
- where capacity cannot easily be substituted in the short term.

2.8 At the same time, it is important that ring-fenced banks, consistent with the objectives of the policy, operate as clearly independent, separate entities, and are not established in such a way as to impede their resolution or the resolution of the wider group (including, for example, by making a private sector sale less viable). The regulator should have powers under ring-fencing legislation to require firms to make changes to their structures in these instances.

What are small and medium sized enterprises for the purposes of ring-fencing?

2.9 The Government believes that a quantitative limit should be used to determine whether a firm's deposits must be held by a ring-fenced bank. A quantitative limit is likely to be the simplest to apply and provide most clarity to market participants; although this will come at the cost of some sophistication and flexibility (for example, some small or low turnover companies have sophisticated needs and are able to cope with disruption to their banking services).

2.10 The threshold could be set by reference to firm turnover, or employee numbers, or a combination of both. The Government proposes that a threshold for mandatory inclusion in a ring-fenced bank be based on annual turnover. Firms with an annual turnover above this threshold would be permitted to place their deposits outside a ring-fenced bank if they chose to do so.

2.11 An appropriate limit is likely to be between the current turnover thresholds for the definition of small and medium-sized enterprises under the Companies Act (2006), i.e. £6.5m and £25.9m. If the threshold were set at an annual turnover of £6.5m, this would mean that 96 per cent of all enterprises (43 per cent of enterprises by employment) would be required to hold their deposits in ring-fenced banks. If the threshold were set at £25.9m, this would mean that 97 per cent of all enterprises (53 per cent of enterprises by employment) would be required to hold their deposits in ring-fenced banks. Firms above this threshold could of course choose to place deposits in ring-fenced banks if they wished, so the actual level of coverage could be much higher.

2.12 Companies' annual turnover will, of course, fluctuate. Where a firm's turnover temporarily dipped below the turnover threshold, it would likely cause unwelcome disruption were that firm to have its deposits transferred immediately from a non-ring-fenced to a ring-fenced bank. The Government therefore proposes that a firm's turnover over a given period be used as a basis for assessing whether it ought to transfer its deposits into a ring-fenced bank.

[3] Either only by ring-fenced banks, or where undertaken in groups containing ring-fenced banks, only in the ring-fenced entity.

2.13 Where a firm with deposits in a non-ring-fenced bank drops below the turnover threshold for a prolonged period, the non-ring-fenced bank would be expected to review the firm's circumstances, and require the transfer of the firm's deposits to a ring-fenced bank. The Government welcomes views on how such a transition would be managed in practice, balancing the need to minimise disruption to customers, while taking steps to ensure that banks do not exploit movement around the boundaries as a means of evading the ring-fencing requirements.

What are high net worth individuals for the purposes of ring-fencing?

2.14 The ICB recommended that high net worth individuals be exempted from the requirement to place their deposits in ring-fenced banks. This would not prevent such individuals from placing deposits in ring-fenced banks if they wished.

2.15 The Government believes that the threshold for such an exemption should be based on an assessment of free and investable assets with a single bank. The Government recognises that the amount of funds that an individual holds with a single bank will not be a complete reflection of their wealth, or indeed indicate an ability to cope with interruptions to banking services. However, assessing an individual's total free and investable assets is difficult for banks to do in practice, and harder to enforce. The Government therefore does not support using an assessment of a customer's *total* free and investable assets.

2.16 The Government believes that an appropriate threshold for exemption is between £250,000 and £750,000 of free and investable assets with a single bank. This threshold would exempt between 0.2 per cent and 0.1 per cent of the population, respectively. Banks use slightly different definitions of free and investable assets. The Government will consider further what definition of free and investable assets should apply in this context. It may, for example, be appropriate to exclude illiquid assets from this definition, as the key factor in being able to cope with an interruption to vital banking services is an individual's liquid wealth.

2.17 Individuals should make an active choice in placing deposits outside the ring-fence in full knowledge of the risks. The Government therefore agrees that a process similar to that followed for the purpose of treating individual investors as professional investors under the Market in Financial Instruments Directive (MiFID) should be instituted to ensure that individuals only have their deposits placed outside the ring-fenced entity should they actively choose to do so, cognisant of the risks and benefits.

2.18 It would not be desirable for an individual to have their deposits transferred immediately from a non-ring-fenced to a ring-fenced bank where their level of free and investable assets temporarily dipped below the threshold required to qualify for an exemption. The Government therefore proposes that an individual's average free and investable assets over a given period be used as a basis for continued compliance with the qualifying criteria for exemption (for example, the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 requires the individual to have a minimum quantity of net assets over a twelve month period (the preceding financial year) to be defined as a high net worth individual for the purposes of that Order).

2.19 As with the requirements for SMEs, where an individual does not meet the threshold for exemption over a prolonged period, a non-ring-fenced bank would be expected to review the individual's circumstances, and where necessary require the transfer of the individual's deposits to a ring-fenced bank. The Government seeks views on how such a transition would be managed in practice, balancing the need to minimise disruption to customers, while taking steps to ensure that the high net worth exemption is not used as a means for evading the ring-fencing requirements.

Consultation question 1

- What are your views on the appropriate threshold above which firms should not be required to place their deposits in a ring-fenced bank?
- Do you believe that firms below this level should have the opportunity to opt out of this requirement if they meet certain criteria? If so, what should those criteria be?
- What are your views on the appropriate threshold above which individuals may opt out of placing deposits in a ring-fenced bank? How should it be measured and at what level should it be set?
- What are your views on the Government's proposals for dealing with instances where SMEs or individuals cross those thresholds? Should this be set as an assessment over a sustained period? What should this period be?

Scope of prohibited services

2.20 Certain services should be excluded from ring-fenced banks, particularly those which impede resolution and/or increase a ring-fenced bank's exposure to shocks from financial markets. It remains the Government's view that ring-fenced banks should largely be prohibited from carrying on international and wholesale and investment banking services to achieve the objectives of the policy set out in paragraph 2.2. The Government proposes that primary legislation should require ring-fenced banks to refrain from carrying on any prohibited activity. One such activity – dealing in investments as principal[4] – will be defined in primary legislation. The Government proposes to take a power to define additional prohibited activities. Prohibited activities will consist both of the provision of particular products, and the provision of services to particular clients.

2.21 The Government also proposes to take a power to define in secondary legislation conditions under which carrying on these activities is not prohibited. In particular, ring-fenced banks will need to engage in activities that might otherwise be prohibited for the purposes of raising wholesale funding and managing liquidity or the risks arising from their core activities of lending and providing payments services. These exemptions are discussed in the ancillary activities section at paragraph 2.46.

Geographical restrictions

2.22 To ensure that cross-border activities do not present a barrier to the resolution of ring-fenced banks, the Government proposes that ring-fenced banks should not carry out any banking activities through non-EEA subsidiaries or branches. Instead, where a ring-fenced bank operates in a wider group, non-EEA operations will have to be undertaken in separate subsidiaries of the group. The presence of overseas subsidiaries and branches within financial groups can significantly complicate the resolution of firms due to the difficulties in establishing claims in multiple jurisdictions and coordinating multiple resolution authorities. These challenges are less likely to be material within the EEA as the Credit Institutions Winding-Up Directive provides a framework for cross-border resolution across the EEA, and the European Commission recently published a proposal for a Recovery and Resolution Directive (RRD) which, once implemented, will further strengthen EEA cross-border resolution.

2.23 Such a restriction would permit a ring-fenced bank to have counterparties outside the EEA, and to hold assets, or make loans secured against assets, outside the EEA provided that this does not create a barrier to resolution. As banking groups will continue to be able to operate

[4] Regulated under Article 14 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (S.I. 2001/544).

outside the EEA through entities elsewhere in the group, including through overseas subsidiaries and branches of UK-incorporated non-ring-fenced banks, and ring-fenced banks will be prohibited from operating non-EEA branches and subsidiaries, the Government expects that the significant majority of ring-fenced banks assets will be lending within the EEA, to customers from the EEA. This will additionally act to preserve the benefits of cross-border retail services provision within the single market.

2.24 The Government also proposes for ring-fenced banks that all major service and credit contracts be written under the laws of an EEA Member State. However, the Government proposes to allow an exception to permit a ring-fenced bank to write contracts under other laws for the purposes of, for example, holding non-EEA sovereign debt for liquidity purposes, or seeking wholesale funding outside the EEA (discussed in paragraph 2.47 below).

2.25 It is possible that in the future cross-border resolution agreements with other non-EEA jurisdictions will emerge that provide resolution authorities a sufficient level of comfort that branches or subsidiaries in those countries will not present a barrier to resolution, nor an increased risk to the UK taxpayer. Where this is the case, arrangements may be made bilaterally to allow for ring-fenced banks to maintain subsidiaries or branches in those jurisdictions. In this regard, the Government is working with the authorities of Guernsey, Jersey and the Isle of Man to establish the conditions under which branches or subsidiaries in those jurisdictions would be consistent with the objectives of ring-fencing.

Consultation question 2

- What are your views on the proposed restrictions on ring-fenced banks' activities outside the EEA?
- Should any further restrictions be applied to the scope of ring-fenced banks' activities to ensure that the objectives should be met?
- What are your views on the costs and benefits of such restrictions?

Financial institution exposure restrictions

2.26 Financial institutions which typically demonstrate a high degree of leverage, liquidity or maturity mismatch or financial interconnectedness can transmit, and often amplify, shocks arising elsewhere in the financial system. Hence banks that are not directly exposed to particular losses in the non-financial sector can find themselves nonetheless vulnerable to those shocks through their connections to other financial institutions. In addition, by creating an exposure to a financial institution undertaking prohibited services, a ring-fenced bank could effectively evade the constraints of ring-fencing and undermine the objectives of the policy.

2.27 This justifies limiting a ring-fenced bank's exposure to financial institutions and the Government therefore proposes to take a power to prohibit a ring-fenced bank from entering into certain transactions with certain financial institutions.

Prohibition or limit

2.28 Restricting exposure to financial institutions could be achieved either by placing an outright prohibition on all such exposures, or by setting quantitative limits on exposures to financial institutions (for example by setting limits on aggregate exposures to financial institutions as a class).[5]

[5] A limit could also incorporate different limits on particular types of financial institution as a proportion of the overall limit (e.g. a limit on interbank exposures and a limit on non-bank financial exposures with different levels for each).

2.29 A quantitative limit may allow greater flexibility, for example enabling tougher restrictions to be applied to specific types of exposure or institution. However, quantitative limits are more vulnerable to erosion over time, while a prohibition provides better protection against evasion. On balance, the Government believes that a prohibition would be most appropriate.

2.30 The Government proposes that ring-fenced banks should therefore be prohibited from entering into any transaction with a financial institution that results in an economic exposure to that institution, other than for the purposes of:

- facilitating payments for other financial institutions (ring-fenced banks should be permitted to settle payments for financial institutions; this will naturally result in exposures, so these activities should be monitored closely so that they do not undermine the aim of the restriction);
- the management of liquidity (where ring-fenced banks may place deposits with other financial institutions and hold claims as part of their liquidity resources, as approved by the regulator); and
- acting as derivatives counterparties for the purposes of ring-fenced banks' risk management (subject to the safeguards described below).[6]

2.31 The restriction should not limit the ability of wholesale investors to hold the debt of ring-fenced banks.[7]

Types of institution

2.32 Not all types of financial institution will have the same capacity to either transmit contagion or offer the same opportunity for arbitrage. The Government believes that those institutions that should be included within the definition of prohibited counterparties are those which a) engage in financial intermediation[8] and b) those which may be highly leveraged, have a high degree of maturity or liquidity mismatch, or have a high degree of financial interconnectedness. These definitions are not binary, and require a degree of judgement.

2.33 The Government proposes that the type of institution that ring-fenced banks should be restricted in their dealings with should include:

- non-ring-fenced banks, or banks that engage in otherwise prohibited activities;
- investment firms;
- funds and fund management companies; and
- insurance companies.

2.34 The Government considers that there are good reasons for the restriction to extend to any off-balance sheet vehicles that are associated with these firms. Most financial institutions that meet this definition are likely to be largely unaffected by being a prohibited counterparty; most typically they will have sophisticated financial needs that can be accommodated by non-ring-fenced banks and the Government will ensure that they will still be able to access ring-fenced banks for payment services. Within this broad definition, however, the Government considers that some exceptions may be made for firms where the potential costs of such a prohibition are more finely balanced against the benefits. These include:

[6] Under this exemption, ring-fenced banks should also be permitted to transact directly with central counterparties (see paragraphs 2.46-2.47).

[7] Although the risks presented by excessive reliance on wholesale funding are very real and should be addressed through strengthened liquidity regulation.

[8] That is, the transformation of financial assets and liabilities with respect to maturity, scale, risk etc. on their own balance sheets.

- friendly societies and small mutual insurers; and
- smaller funds, for example those beneath the threshold proposed in the Alternative Investment Funds Management Directive (€100m leveraged and €500m unleveraged).

2.35 The Government proposes that definitions of institutions based on activities as described in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (RAO) should be used to define those institutions which are to be prohibited counterparties. This has the advantage of being operationally relatively straightforward and difficult to evade, as well as allowing for distinctions to be made between different types of activity that entities undertake. The existing RAO definitions will need to be supplemented to ensure a) that off-balance sheet vehicles of prohibited financial institutions are captured and b) that non-EEA firms that undertake an activity which would be a regulated activity if it was carried out in the UK also come within the scope of the proposed prohibition.

Consultation question 3

- What are your views on the restrictions on ring-fenced banks' exposures to financial institutions as proposed?
- What are your views on the types of exposure that should be permitted or prohibited?
- What are your views on the types of institution that should be classified as financial for these purposes?
- What are your views on how these restrictions should operate in practice?

Financial product restrictions

2.36 The co-mingling of some activities can expose ring-fenced banks to risks that are not fundamental to the business of intermediating between savers and borrowers and providing payments services. The Government believes that the following activities should certainly be prohibited activities:

- origination, trading, lending or making markets in securities (including structured investment products) or derivatives;
- secondary market purchases of loans and other financial instruments;
- conduit financing or securitisation of assets originated outside the ring-fenced bank;[9] and
- underwriting of securities issues.

2.37 The Government has stated that it will take a precautionary approach to determining which activities are prohibited. As noted above, the Government proposes to provide in primary legislation that dealing in investments as principal will be a prohibited activity (other than for liquidity purposes, as discussed below).[10] The Government also proposes to take a power to provide in secondary legislation for additional prohibited activities. This power could be used to

[9] Under the ICB's ancillary activities principle, the ring-fenced bank would be permitted to package cash flows from pools of assets originated on its balance sheet – for example residential mortgages – into securities and sell these to investors.

[10] Dealing in investments as principal is a regulated activity under article 14 of the RAO (S.I. 2001/544). The activity as described in that provision is "buying, selling, subscribing for or underwriting securities or contractually based investments". The FSA Handbook defines the scope of these investments in the following link: http://fsahandbook.info/FSA/glossary-html/handbook/Glossary/D?definition=G282

ensure that dealing in other derivatives is also a prohibited activity, even where the derivatives in question do not come within the definition of "investments" for the purposes of the RAO.[11]

2.38 The ICB said a ring-fenced bank could offer some risk management products to its clients, provided it did so in a way which did not give rise to increased exposure to market risk, and that the services were sufficiently simple that they did not threaten resolvability.[12] Consequently, the Government committed to examine a prohibited activities policy framework which would allow a ring-fenced bank to sell simple derivatives to its customers. The development of this framework will take into account a) the significant advances in the regulation of financial instruments at EU level, which will serve to make derivative activity less volatile and easier to manage;[13] and b) the frictional costs that might be imposed on customers if ring-fenced banks were unable to provide some services directly to them.

2.39 It is the Government's view that a ring-fenced bank may be permitted to provide 'simple' derivatives products to its customers, provided that a number of conditions are met. The Government proposes to take a power to set out in secondary legislation the conditions in which ring-fenced banks may deal in investments as principal. These conditions will likely be defined by reference to a combination of: the type of contract provided; the customer to whom the contract is provided; and the manner in which the contract is managed.

2.40 These proposals will enable ring-fenced banks to provide a full range of services to individuals and SME customers, while ensuring that the vast majority of other investment banking services remain firmly outside the ring-fence.

2.41 First, it will be important to define the types of product ring-fenced banks are permitted to trade, in order to ensure that product complexity provides no barriers to resolution. The appropriate definition of a 'simple' derivative could be one, or a combination of, the following:

- an instrument whose purpose is to fix or cap client market exposures to interest rate or foreign exchange rate risk related to the business of the ring-fenced bank (for example lending and payments services);
- an instrument defined by the Prudential Regulation Authority (PRA) as standardised and for the purpose of hedging only interest rate and/or foreign exchange risk in deep and liquid markets (for example no derivatives classified as Level 2 or 3 under the fair value hierarchy).[14]

2.42 Second, possible limits on the customer to whom a contract may be provided are:

- an instrument may be provided only to the holders of mandated deposits, i.e. households and SMEs; and
- an instrument may be provided only to non-financial institutions (unless for own balance sheet management).

[11] For example, under the RAO not all dealing in foreign exchange derivatives and commodity derivatives come within this definition.

[12] *Final Report: Recommendations,* Independent Commission on Banking, September 2011, paragraph 3.43.

[13] MiFID II aims to introduce conduct of business rules for providers of financial instruments and more effective, efficient and safe operation of financial markets. Coupled with the European Market Infrastructure Regulation (EMIR), it aims to increase stability within over-the-counter (OTC) derivative markets and gives effect to the G20's commitment to deliver the Financial Stability Board's recommendation that all standardised OTC derivatives should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by the end of 2012 at the latest.

[14] Fair value measurements in Levels 2 and 3 of the fair value hierarchy are determined using valuation techniques and not quoted prices directly observable in active markets. In particular, Level 3 assets are those whose fair value cannot be determined using observable measures, such as market prices or models. Level 3 assets are considered illiquid, and fair values can only be calculated using estimates or risk-adjusted value ranges. Banks with a high proportion of Level 3 assets on their balance sheets would likely face severe problems in market valuation in case of distress, thus affecting market confidence.

2.43 Third, exemptions to the general prohibition on trading derivatives would have to be made on certain conditions. These conditions will be designed to ensure that ring-fenced banks can manage market and counterparty risk arising from derivatives exposures, and to ensure the ring-fenced bank's portfolio of derivatives can be unwound or transferred in the event of failure. For example:

- hedging net market risk may be permitted if the ring-fenced bank conducts these hedges using standardised derivative transactions, on an arm's length, third party basis;
- hedging derivatives may be permitted if they are centrally cleared or subject to standardised International Swaps and Derivatives Association (ISDA) contracts with daily mark-to-market margin calls and resulting collateralisation, with that collateral in the form of cash or high quality security held by the ring-fenced bank;
- residual market exposure would need to be capped at a percentage of a ring-fenced bank's Tier 1 capital (which should be operationally as close to zero as possible), and counterparty credit risk must be adequately collateralised at all times;
- a ring-fenced bank's derivatives netting arrangements would need to respect the economic independence of the ring-fenced bank from the rest of its group and not impede the resolution of the ring-fenced bank or result in other adverse consequences for the wider group in the event of failure;
- restrictions may need to be placed on the laws governing a ring-fenced bank's derivatives contracts; and
- derivatives contracts may not contain clauses providing for cross-default or early termination on the exercise of resolution actions unless a failure to pay or deliver collateral to meet margin calls occurs.

2.44 This is not intended to be an exhaustive list of safeguards.[15] These safeguards will serve to insulate the ring-fenced bank from shocks arising from its derivative portfolio and ensure that it does not present barriers to the firm's successful separation from the rest of its group and resolution in the event of difficulties. Standardised contracts, daily margin calls and collateralisation help to ensure that the failures of counterparties or losses on derivatives positions do not impose unmanageable costs on ring-fenced banks. These safeguards also help in resolution by ensuring that derivatives contracts can be transferred, novated or closed out without the challenges that come from dealing with more complex and larger derivatives portfolios.

2.45 Certain forms of retail investment products, also known as structured retail deposits, are designed to provide bank depositors with higher returns by investing deposits in different types of market risk, for example by providing equity- or index-linked returns. Provision of these products may expose banks to increased risks across a variety of global financial markets and require the use of complex derivatives to manage those risks. Extensive use of these products could hinder resolution and the insulation of a ring-fenced bank from global shocks. At the same time, some forms of structured deposit may be fairly simple and can be provided in ways that are relatively safe. Some products (for example capital protected deposits) are treated as deposits for the purposes of Financial Services Compensation Scheme (FSCS) protection. The Government welcomes views on how simple retail investment products may be provided by ring-fenced banks in a way that is consistent with the resolution and insulation principles described above.

[15] The application of safeguards will need to take into account the differences between financial and non-financial counterparties. It would not be appropriate for some requirements to apply in the case of derivatives contracts between ring-fenced banks and small, non-financial counterparties, for example.

Consultation question 4

- What are your views on the scope of activities to be prohibited? Should any other activities be included or excluded?
- What are your views on the conditions proposed for exempting the provision of certain derivatives to third parties from the general prohibition on trading in derivatives?
- What are your views on the desirability of permitting ring-fenced banks to sell retail investment products?

The scope of ancillary activities

2.46 The Government proposes to take a power to provide in secondary legislation for exemptions to prohibited activities for the purposes of:

- managing balance sheet risks;
- liquidity management; and
- raising funding.

2.47 As discussed above, an exemption could be provided for to permit, for example, engaging in derivatives transactions in order to manage the interest rate and other risks that arise from lending to customers. An exemption could also be made to allow a ring-fenced bank to enter into transactions with financial institutions, such as holding another financial institution's short-term debt, for the purposes of managing liquidity, or buying and selling sovereign debt for the purposes of holding a buffer of liquid assets. A further exemption could be made to ensure that no undue restrictions were placed on the ability of a ring-fenced bank to issue debt outside the EEA.

Safeguards on ancillary activities

2.48 The ICB did not recommend that any particular safeguards be applied to the proposed exemption to prohibited activities. The Government is considering whether such exemptions should be subject to safeguards on trading in derivatives similar to those proposed for the provision of risk management products for customers, as discussed in paragraph 2.43. Without such safeguards a ring-fenced bank could potentially expose itself to much higher levels of market risk and counterparty credit risk and develop a portfolio of derivatives positions that may be hard to resolve in a crisis.

Wholesale funding

2.49 A ring-fenced bank will need to fund itself. The ICB recommended that a ring-fenced bank's dependence on wholesale funding be restricted. Reducing reliance on wholesale funding is a way of ensuring that ring-fenced banks run less risk of funding and liquidity shocks, such as those experienced in the recent crisis.

2.50 The Government supports the aim of reducing dependency on short-term wholesale funding, but does not support introducing a separate limit on wholesale funding for ring-fenced banks at this stage. A liquidity regime is being developed internationally through the Basel Committee on Banking Supervision (BCBS). Any additional limits for ring-fenced banks should be considered in light of the final development of such a regime.

2.51 The Government agrees with the ICB's recommendation that a ring-fenced bank should only be permitted to package cash flows from pools of assets that are originated on its own balance sheet.

Consultation question 5

- What are your views on the proposed exemptions to prohibited activities for the purposes of balance sheet management, liquidity management and funding?
- What are your views on appropriate safeguards to ensure that this exemption does not give rise to greater risk or evasion of the objectives of the policy?

Intra-group relationships

2.52 A high degree of legal, operational and economic independence is necessary for the ring-fence to be credible and effective. A ring-fenced bank must be sufficiently insulated from the rest of its group to ensure that a failure in one part of the group does not prejudice the continuous provision of services the ring-fenced bank provides.

2.53 Many of the rules that govern economic independence will need to be laid out by regulatory rule and adapted as market behaviour evolves. The Government proposes that the regulator should ensure that, as far as possible, a ring-fenced bank's stability is not dependent on the financial health of the rest of its group. To meet this principle, the Government proposes to require in primary legislation that the regulator ensures that a ring-fenced bank treats, and is treated by, other members of its group as a third party.

2.54 In the main, this will entail applying existing rules to the relationship between a ring-fenced bank and the rest of its group. However, there will be areas in which additional rules are necessary and which the regulator will need to develop. Primary legislation will identify those areas in which the Government considers that the regulator will need to make rules to safeguard the independence of ring-fenced banks.

2.55 Applying these rules may require the regulator to impose requirements on different entities in a banking group, including unregulated parent entities of a ring-fenced bank. The Financial Services Bill confers substantive powers in relation to certain unregulated parent undertakings of authorised persons. The Government proposes to explore whether there is merit in extending these powers with reference to ring-fencing, in order to ensure that the proposals may be delivered effectively.

Legal and operational links

2.56 The legal and operational links within a banking group should be based on the principle that a ring-fenced bank is:

- credibly and easily separable in a period of stress; and
- able to demonstrate its operational independence at all times.

Ownership and legal structure

2.57 The Government proposes that ring-fenced banks are required to be separate legal entities from non-ring-fenced banks.

2.58 The Government proposes to take a power to restrict the subsidiaries a ring-fenced bank may have. This would mean that a ring-fenced bank could not own, or hold the capital of non-ring-fenced entities in the rest of its corporate group.[16]

[16] Exceptions to a general rule that the ring-fenced bank may not have subsidiaries will be considered to permit essential operational subsidiaries such as IT companies.

Operational independence

2.59 Providing that banks abide by the principles set out above, and the operational separability criteria set out in the Government's response in December, the Government believes that banking groups should remain free to organise their operational structures as they choose. However, where the operational infrastructure of a banking group – its management information systems, information technology, employment structures etc. – present a barrier to the separation of a ring-fenced bank and continuous provision of its services, the Government believes that the regulator should, consistent with its existing objectives and its objectives under the ring-fencing legislation, require firms to make appropriate changes to their operations.

Payment systems

2.60 The provision of payment systems should not undermine the purpose or effectiveness of the ring-fence. Correspondent banking relationships involve credit and liquidity exposures between banks. Ring-fenced banks should not be permitted to use non-ring-fenced banks to access business-critical UK payment systems. Provision by ring-fenced banks of payment services to non-ring-fenced banks will be subject to approval. In order to obtain such approval, banks would need to demonstrate that exposures and commitments that arise as a result of a ring-fenced bank providing credit or liquidity to a customer bank are within acceptable limits, and are appropriately collateralised.

Economic links

Liquidity and capital requirements

2.61 The Government expects that ring-fenced banks should meet capital and liquidity requirements on a standalone basis. Where there are a number of ring-fenced banks in a single group, it may be appropriate for the regulator to apply those requirements as a sub-consolidated group of ring-fenced banks, subject to EU law.

Limits on large exposures

2.62 Limits on banks' large exposures to a single counterparty or group of connected clients are designed to avoid a bank being exposed to significant losses in the event of the default of those counterparties.[17] The Government believes that the regulator should establish rules on intra-group exposures to ensure that a) the failure of one part of the group does not transmit to other parts; and b) ring-fenced and non-ring-fenced entities are credibly independent and viable from a capital and funding perspective on their own. Imposing a limit on the amount that a non-ring-fenced bank can lend its ring-fenced affiliate may also act as a backstop to ensure that banks do not try to evade the purpose of ring-fencing restrictions through, for example, mispricing collateral involved in lending arrangements.

2.63 The Government believes that, to achieve the objective of economic independence, it would be appropriate for limits on intra-group exposures to be treated as if those exposures were between third parties.[18]

2.64 Although there are not comparable large exposure limits between third parties measured gross of collateral, the Government believes that there is a strong argument for imposing such limits on exposures between ring-fenced banks and the rest of their groups, subject to EU law. Such limits were recommended by the ICB. Collateral may not be wholly reliable in a period of

[17] Article 111, Directive 2006/48/EC imposes a limit on large exposures of credit institutions.

[18] The current Large Exposures regime (Directive 2009/111/EC) limits an institution's banking book exposures to any counterparty, group of connected clients or connected counterparties to 25 per cent of the institution's regulatory capital. In addition, the institution must not incur large exposures which in total exceed 800 per cent of regulatory capital.

stress, as demonstrated during the recent crisis, and banking groups have incentives to mis-state the value of collateral for internal transactions, which true third parties may not.

2.65 The recommendations of the BCBS Large Exposures Group, due to report in December 2012, should be taken into account in calibrating such intra-group exposure limits.

Intra-group funding

2.66 Another means by which a ring-fenced bank is vulnerable to failure or weakness in the rest of its group is if it is heavily dependent on the rest of the group for its funding. By withdrawing funding in periods of stress, a group can expose a ring-fenced bank to funding and liquidity risks, as it searches for new sources of funding in periods of low market supply. Reducing reliance on the rest of the group for funding also enhances the perception of the independent viability of the ring-fenced bank.

2.67 The risks of sudden funding withdrawals can also be partially mitigated by regulating the terms of that lending. If funding to a ring-fenced bank is staggered and maintained at a sufficient maturity, the dramatic impact of a funding shock may be diminished. On the other hand, such arrangements may never provide complete comfort, so a limit is likely to continue to be appropriate.

2.68 The Government therefore believes that the regulator should be required to set limits on the proportion of its funding that a ring-fenced bank receives from the rest of its group, and for the terms of that funding to be regulated, to ensure that the economic independence of a ring-fenced bank is not compromised. The final calibration of such a limit will need, of course, to take into account the final shape of loss-absorbency requirements and be considered within the context of the European Commission's proposed RRD.

Other intra-group transactions

2.69 Although not directly captured by existing regulation, the Government is considering whether to require the regulator to set out rules in a number of areas where there may be potential for transactions that either a) seek to avoid the impact of the rules above, or b) undermine the independence of the ring-fenced bank and expose it to risks of failure in the rest of the group. In particular, the regulator will need to consider carefully the case for additional rules in the following areas:

- ensuring that intra-group transactions, including loans, asset swaps and sales are undertaken under market conditions;
- ensuring that such intra-group transactions are taken into account when setting intra-group funding limits;
- restricting or prohibiting intra-group guarantees;
- prohibiting cross-default clauses, e.g. in derivatives contracts; and
- prohibitions on intra-group netting agreements between ring-fenced and non-ring-fenced derivatives counterparties.

Consultation question 6

- What are your views on the principles of ring-fenced bank independence set out in this white paper?
- What are your views on the balance between legislation and rules for the purposes of ensuring that a ring-fenced bank remains independent of the financial fortunes of the rest of its group?
- What are your views on the advantages and disadvantages of different corporate and operational structures for the purposes of ring-fencing?
- What are your views on the appropriateness of restrictions on intra-group transactions discussed in this white paper?
- What other forms of intra-group relationship should the Government and regulator focus on to ensure that the objectives are delivered?
- What are your views on the advantages and disadvantages of providing the regulator additional powers over parent undertakings of authorised persons or other unregulated entities for the purposes of the proposals set out in this white paper?

Governance

2.70 The independence of a ring-fenced bank must be underpinned by strong governance. The key to independent governance will be:

- the composition of the board; and
- a requirement on board members to act in the interests of the ring-fenced bank and protect the ring-fence.

2.71 In the view of the Government, it would be appropriate that at least half the board of the ring-fenced bank, excluding the Chair, are independent, consistent with the UK Corporate Governance Code. So, for example, a board member should not have had a material business relationship with the ring-fenced bank, or the rest of the group within the last three years. It is important that the Chair of the ring-fenced bank is independent on appointment. In addition the Government believes that no more than one third of the members of the ring-fenced bank's board may be representatives of the rest of the group (either as board members of the wider group or executives). This limit should balance the need to represent the ring-fenced bank's interests within the main group, maintain strategic coherence with the rest of the group, while limiting the possibility of the group exerting undue influence upon the ring-fenced bank's board. The restriction on cross-membership would not apply to the boards within a group of ring-fenced banks. As discussed in the Government's response in December, the Government supports flexibility in these arrangements where a ring-fenced bank represents the overwhelming majority of a group's business.

2.72 The Government agrees that there is a strong case for there to be an extra requirement for directors of the ring-fenced bank, and the parent company, to protect the integrity of the ring-fence. This requirement could be implemented through the regulator's Approved Persons regime.

2.73 In addition, the Government believes there is a strong case for ring-fenced banks having their own board committees, in particular regarding risk, and possibly nomination and remuneration. It is important that the governance structure of a ring-fenced bank reflects, to the extent possible, its independent nature and operates to align the incentives and culture of those working in the ring-fenced bank to reinforce that independence. For this reason, independence in selecting the board, in setting a risk appetite for the firm and in setting its pay structures, should be primarily a matter for the ring-fenced bank.

Consultation question 7

- What are your views on the proposed governance arrangements for ring-fenced banks?
- What are your views on appropriate exemptions for firms whose business is predominantly conducted from within the ring-fenced entity?

Disclosure

2.74 A ring-fenced bank needs to demonstrate publicly that it is independent. The Government does not agree that this is best achieved by requiring a ring-fenced bank to make disclosures as if it were independently listed on the London Stock Exchange. Listing requirements are not intended to deliver such an outcome. It is likely that significant ring-fenced banks will already be required to make a number of public disclosures under Pillar III and other existing regulatory and listing requirements. Where this is not sufficient to demonstrate that a ring-fenced bank is an independent, viable entity, the regulator will have, subject to EU law, a broad power to require any additional disclosures considered appropriate for the purposes of demonstrating independence.

Consultation question 8

- What are your views on the proposals for disclosure requirements for ring-fenced banks? Are there specific areas of disclosure that should be required in order to demonstrate the independence of the ring-fenced entity?

Tax

2.75 The Government has identified two main tax issues arising as a result of the ICB's recommendations in relation to ring-fencing: a) VAT grouping and b) losses carried forward. There are also important tax issues in relation to the bail-in tool, which are discussed in Chapter 3.

2.76 The tax liabilities of banks should neither give rise to contagion which could potentially be transmitted to ring-fenced banks, nor impede their resolvability. The ICB identified the joint and several liability from VAT grouping as an area that could create a tax exposure that could undermine the resolvability of ring-fenced banks. The ICB recommended that ring-fenced banks should be removed from VAT groups, or that the impact of their involuntary obligations to meet the VAT exposures of their wider corporate group should be mitigated. The Government is exploring how this risk could be mitigated, for example by requiring non-ring-fenced banks to place a deposit or security with ring-fenced banks.

2.77 The ring-fence is likely to affect 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. This may mean banks will pay tax earlier than they would have done in the absence of the ring-fence.

Consultation question 9

- What are your views on possible approaches to mitigate the risk of a ring-fenced bank being jointly and severally liable for VAT obligations of its wider corporate group?
- What is the potential impact of ring-fencing on banks' carried forward losses?
- Are there other intra-group tax exposures that could affect the ring-fenced bank, or other tax issues arising from the creation of the ring-fence?

Pensions

2.78 The Government recognises that under current pension regulation there are circumstances where a ring-fenced bank may be liable for funding any deficit in group-wide pension schemes should the wider banking group fail. This may threaten the economic independence of any ring-fenced bank which is jointly and severally liable for contributing towards pension deficits arising elsewhere in the group. The ICB recommended removing the ring-fenced bank's liability for wider banking group pension liabilities, or ensuring that its impact is mitigated.

2.79 The Government's preferred option is to require banks to separate, using commercial means, the pension fund for employees of a ring-fenced bank from the pension funds of other group entities, to ensure that the ring-fenced bank cannot be made jointly and severally liable for any pension deficit arising elsewhere in the group. At the moment the size of banks' pension deficits makes a split in the near term problematic. The Government therefore believes that banks should be allowed a period of time in order to achieve this separation. The Government proposes that banks should be given until 2025 to achieve full separation of their pension schemes. The Government welcomes views on the appropriateness of this date. The provision of additional time to achieve this separation would not be intended to increase the time allowed for banks to fulfil their recovery plan agreements with pension trustees. Banks and trustees will need to agree appropriate plans necessary to ensure that banks are able to afford a separation by the 2025 deadline.

Consultation question 10

- What are your views on alternative ways of ensuring that ring-fenced banks are not subject to joint and several liability in relation to pension deficits?
- What are your views on an appropriate date by which firms should be required to separate their pension schemes? Would 2025 allow banks sufficient time to mitigate the costs of a separation?

Scope of these proposals

2.80 The Government's response to the ICB's recommendations said that the ring-fencing requirements would apply to any company or other body incorporated in the UK which undertakes a banking business with permission from the UK regulator. This would include any UK bank or building society, including UK subsidiaries of UK or non-UK headquartered banking groups.

2.81 Following further analysis the Government believes that imposing ring-fencing requirements on building societies would be unnecessarily burdensome, as it would mean that building societies would have to comply with two different sets of legislative requirements operating in substantially the same area. Therefore, the Government has decided to carve the entire building societies sector out of the ring-fencing legislation. The Government will then, while ensuring that the distinctiveness of the sector is maintained, bring building societies legislation into line with ring-fencing requirements by making appropriate amendments to the Building Societies Act (1986). The Government believes that the arguments for adequate loss-absorbency hold for the mutual model as well as for the banks. The Government will therefore include building societies in any of the general loss-absorbency measures that apply to banks of a similar profile. The Government will set out the full detail of its proposals for building societies, together with its aspirations for the building society sector in a discussion document *The Future of Building Societies*. This document will be published shortly.

De minimis

2.82 The Government believes there is a case for an exemption from the requirements of ring-fencing for certain firms, as discussed in its December response. These are firms where ring-fencing activities would likely make only a small difference to the possibility of resolving those firms without taxpayer support, or insulating those activities from financial shocks, but potentially have a large marginal cost relative to other firms, and so affect their ability to compete effectively.

2.83 There are a number of ways to measure such firms, for example:

- asset size (total assets or risk-weighted assets); and
- deposits (total or mandated, protected, retail or sight only).

2.84 These measures could be expressed in absolute terms, as a percentage of GDP, as a market share, or as a percentage of a firm's balance sheet or liquid assets (deposits). The Government believes that the most appropriate measure would be the size of deposits which qualify as mandated for the purposes of ring-fencing. This measure is most likely to reflect the level of benefit derived from ring-fencing vital banking services in a particular firm relative to the costs. At the same time, there is a higher risk that this threshold will fluctuate more often, as firms can adjust their funding from mandated deposits to other forms of funding more easily than adjust their overall balance sheet size.

2.85 The Government believes that a threshold set at £25bn of mandated deposits (or 1.8 per cent of GDP) may be an appropriate threshold below which firms are not required to ring-fence their deposits from individuals and SMEs. This threshold will need to adjust over time to reflect the evolution of banking practices and growth in the deposit base. Mandated deposits are not currently measured. Using deposits eligible for protection under the FSCS, which may be a close proxy, if the threshold were £25bn, approximately 87 per cent of the banking sector by deposits would be automatically covered by ring-fencing.[19]

2.86 As firms approach the thresholds for exemption, either from below, or above, provision will need to be made for firms to adapt to different requirements. Exemption from ring-fencing requirements will mean that those firms are not subject to restrictions on their counterparties, the activities that they can undertake, or the conditions under which they can operate their businesses. To ensure consistency with ring-fenced entities, the Government will consider with the regulator whether additional prudential safeguards should be applied to certain exempted banks. This may also help to deal with any 'cliff edge' effects as firms approach the thresholds.

Branches of non-EEA headquartered firms

2.87 The Government considers that the exemption thresholds should also apply to branches of non-EEA headquartered firms. While otherwise exempted, should the proportion of UK retail deposits that they hold exceed the thresholds, they will be expected to comply with the

[19] 90 per cent of all deposits eligible for protection under the FSCS would be held in either building societies or ring-fenced banks.

requirements set out in this paper. A non-EEA headquartered firm in this position will be required to incorporate a subsidiary to accept deposits in the UK, and it will no longer be permitted to accept deposits through a branch. Currently, no branch of a non-EEA headquartered firm is likely to exceed the thresholds set out in this white paper.

Consultation question 11

- What are your views on the appropriateness of applying a threshold below which firms are not required to introduce a ring-fence?
- How do you believe that such a threshold should be set?
- Where do you believe an appropriate threshold should be set?
- What are your views on dealing with firms who approach the threshold?
- What are your views on the proposed treatment of building societies and branches of non-EEA firms?

3 Loss-absorbency

3.1 This chapter sets out the Government's proposals with respect to increasing banks' capacity to absorb losses. It concerns proposals on the 'primary loss-absorbing capacity' held by banks, proposals for a bail-in tool, a leverage ratio, and depositor preference. This part of the UK banking reform package is as important as structural reform. International and UK efforts to improve banks' loss-absorbency, consistent with the ICB, focus on making sure that banks:

- are well capitalised to survive shocks, holding sufficient *going concern* loss-absorbing capacity to reduce their probability of failure; and
- are required to hold sufficient *gone concern* loss-absorbing liabilities that can bear losses so that if a bank does fail, the resolution authorities can resolve it by, if necessary, imposing losses on these liabilities rather than relying on public funds.[1]

3.2 The Government strongly supports the new Basel III capital standards, and will continue to seek to implement them in full through the Capital Requirements Directive IV (CRD IV)/Capital Requirements Regulation (CRR). In addition, the Government is very supportive of international and European plans to require jurisdictions to establish a statutory bail-in mechanism as part of a resolution regime, so that losses may be imposed on creditors should a bank be placed into resolution. Within the EU, this mechanism could be further strengthened through rigorous reform of the banking state aid framework.

3.3 The Government sets out here proposals for ensuring that ring-fenced banks and UK-headquartered global systemically important banks (G-SIBs) have sufficient loss-absorbing capacity (including loss-absorbing debt), building on the position set out in the Government's December response.

Primary loss-absorbing capacity (PLAC)

3.4 The Government believes banks should hold minimum levels of effective loss-absorbing capacity that bears losses ahead of other liabilities (primary loss-absorbing capacity or PLAC) to ensure they are sufficiently resilient to shocks, and so that they can be resolved without recourse to the taxpayer.

3.5 The ICB said that UK-headquartered G-SIBs and ring-fenced banks should be required to hold certain levels of PLAC, with 17 per cent of risk weighted assets (RWAs) the requirement for the largest firms. The ICB recommended that PLAC should comprise equity, Additional Tier 1 (AT1) capital, and Tier 2 (T2) capital (here collectively referred to as capital), as well as long-term unsecured debt clearly subject to a statutory bail-in power.[2]

3.6 The Government continues to support a PLAC requirement of up to 17 per cent for UK-headquartered G-SIBs and ring-fenced banks, and takes the view that it is appropriate to calibrate this requirement against RWAs in line with the principle that the primary determinant of a bank's loss-absorbency requirement should take account of the riskiness of its assets. The

[1] Gone concern loss-absorbing liabilities are those that can bear losses once a bank enters resolution or insolvency. Going concern loss-absorbing liabilities can bear losses before this point.

[2] This is discussed in the bail-in section below.

Government strongly supports international work to strengthen transparency and consistency of RWA measurements of globally systemic banks.

3.7 Provided that banks meet their minimum regulatory capital requirements, the Government does not propose to specify how the total PLAC requirement for each bank is met.[3] A firm could choose to meet its entire PLAC requirement by holding equity if it so wished.

3.8 The question of which particular debt liabilities should be eligible to count towards PLAC is discussed in the bail-in section below (paragraph 3.31 onwards). It is important to note that the scope of the bail-in tool will not be limited only to PLAC. There will be some liabilities not eligible to count towards PLAC that will be within the scope of a statutory bail-in power. This power is necessary to ensure that at least some unsecured debt liabilities can absorb losses before a bank reaches the point of insolvency.

3.9 The European Commission's recently published proposal[4] for the Recovery and Resolution Directive (RRD) includes a requirement on Member States to ensure that credit institutions and investment firms maintain a minimum amount of 'eligible liabilities' (i.e. liabilities that may be bailed in using the bail-in tool referred to in that text). This requirement broadly resembles the PLAC requirement as envisaged by the ICB. Therefore, the Government will seek to deliver a PLAC-type requirement through the RRD. Depending on the final RRD outcome, the Government proposes to impose a duty on the Prudential Regulation Authority (PRA) to apply a PLAC requirement on ring-fenced banks, on large building societies,[5] and on UK-headquartered G-SIBs, in accordance with conditions set out by HM Treasury in secondary legislation. This chapter discusses the outcomes HM Treasury will seek to achieve in setting those conditions (or, as appropriate, through European negotiations).

PLAC requirement for ring-fenced banks (and systemic building societies)

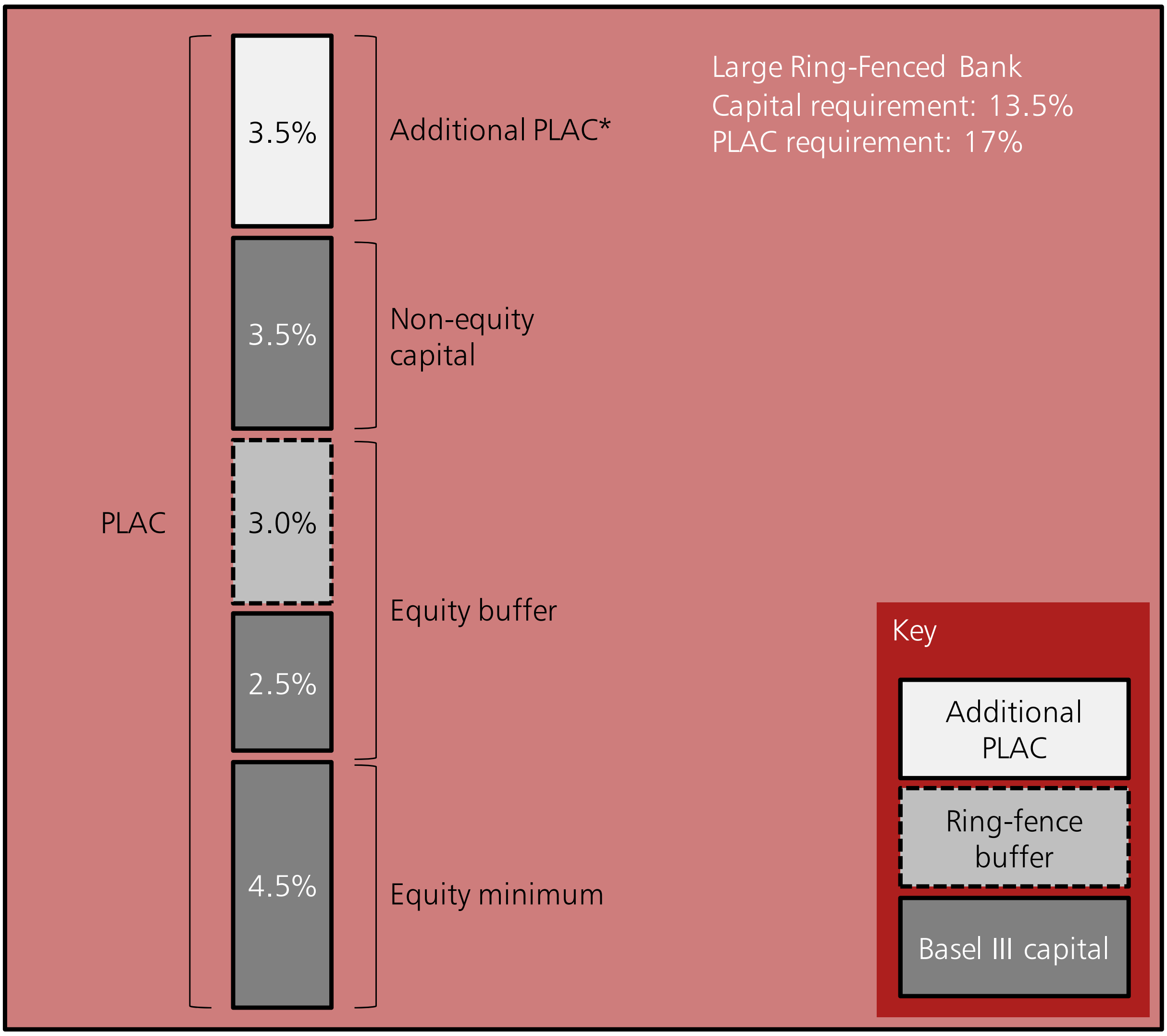
3.10 The Government believes that, as the ICB recommended, ring-fenced banks should hold more equity than that required under the Basel III international standards (this additional equity requirement forms part of the 17 per cent PLAC requirement outlined above). An illustration of the PLAC requirement for a large ring-fenced bank is set out in Figure 3.A. The Government, through CRD IV/CRR and RRD negotiations, is working to ensure that this can be implemented in accordance with EU law.

[3] The regulator also has existing 'Pillar 2' powers conferred on it through implementation of European legislation. These allow it to set additional discretionary capital requirements above and beyond minimum requirements (including those described in this chapter), on a firm-by-firm basis and in accordance with conditions set out in European law in relation to the use of Pillar 2.

[4] http://ec.europa.eu/internal_market/bank/docs/crisis-management/2012_eu_framework/COM_2012_280_en.pdf

[5] For the remainder of this chapter it should be assumed that any requirements that are to be applied to large ring-fenced banks will also apply to similarly systemic building societies.

Figure 3.A: Illustrative PLAC requirement for a large ring-fenced bank



*This could consist of either equity, non-equity capital, or highest quality loss-absorbing debt.

The ring-fence buffer

3.11 The Government agrees with the ICB that it would be appropriate for the regulator to require large ring-fenced banks to hold an additional 3 per cent equity buffer on top of the Basel III minimum standards – this is a proportionate measure to ensure that these firms, which provide vital services to the UK economy, are more resilient to shocks.

3.12 This 'ring-fence buffer' should extend the Basel III capital conservation buffer range,[6] such that large ring-fenced banks would be expected, in normal periods, to operate with a minimum equity-to-RWAs ratio of 10 per cent. However, the ring-fence buffer and any G-SIB surcharge should not be additive so, if an entity is a ring-fenced bank and part of a G-SIB (or is a G-SIB itself), only the higher of the two requirements should apply. Both requirements would be additional to the base capital conservation buffer of 2.5 per cent, and to any counter-cyclical buffer.

3.13 Accordingly, the ring-fence buffer should not raise the 'hard' minimum equity requirement; rather its breach should lead to regulatory restrictions on capital distributions (such as dividends and bonuses) so that a bank's equity levels are rebuilt.

[6] See *Basel III: A global regulatory framework for more resilient banks and banking systems* (http://www.bis.org/publ/bcbs189.pdf) for details on the operation of the capital conservation buffer.

3.14 The failure of small banks and building societies is unlikely to be systemic, therefore the Government does not believe that this additional equity requirement should be applied to them.

3.15 Assuming the necessary powers are conferred on it in through CRD IV/CRR (the most recent draft includes a 'Systemic Risk Buffer' which should be the appropriate channel), the Government believes that in principle the regulator should apply the full 3 per cent buffer to the biggest ring-fenced banks, no buffer to the smallest, and that there may be a case for scaling the ring-fence buffer for banks in between.

3.16 The Government believes it is appropriate to await the outcome of the Financial Stability Board's (FSB) work on domestic systemically-important banks (D-SIBs)[7] before any final decisions are taken on how the buffer might be scaled. This will ensure that any scaling mechanism can be developed to take on board any relevant international best practice in relation to the risks posed by domestic-facing banks. There would also be potential advantages in adopting a methodology that is consistent with internationally-agreed proposals.

3.17 The Government believes that there may be good arguments for the regulator to apply the ring-fence buffer to ring-fenced banks on a solo basis, or at the level of the sub-consolidated 'ring-fenced group' if there is a sub-group of multiple ring-fenced bank entities within a single banking group.

Leverage ratio

3.18 An international consensus has developed that a leverage ratio (a minimum capital requirement that is independent of banks' risk-weights) would be a useful backstop to risk-based capital ratios. Basel III proposed that banks should be benchmarked against a 3 per cent Tier 1 leverage ratio (with the design and calibration of the ratio to be reviewed in 2017), with the view to introduce a binding minimum leverage ratio from 2018. The Government strongly endorses the principle of a backstop leverage requirement, and will continue to press for full implementation of Basel III in the UK through European legislation.

3.19 The argument has been made that the Government should apply a higher leverage ratio to large ring-fenced banks. However, to do so would be inconsistent with international standards and the methods underpinning those standards – in particular, the Government notes that the Basel Committee on Banking Supervision (BCBS) did not recommend that the leverage ratio be increased alongside risk-weighted capital ratios for G-SIBs. Increasing the leverage ratio would also risk making it the primary capital constraint on banks, rather than a backstop to risk-based capital ratios, and would particularly impact some institutions that performed well compared to others during the recent crisis.

3.20 The Government does not therefore see a case for regulators permanently to increase the minimum leverage ratio beyond the Basel III international standard for large ring-fenced banks, as proposed by the ICB.

3.21 The Government notes in this context the interim Financial Policy Committee's (FPC) recommendation that a leverage ratio tool should form part of the permanent FPC's initial macro-prudential toolkit. The Government will consult on its proposals for the FPC's toolkit during the passage of the Financial Services Bill.

PLAC

3.22 The Government believes that 17 per cent of RWAs is the appropriate PLAC (i.e. capital plus highest-quality loss-absorbing debt) requirement for the *largest* ring-fenced banks. Consistent with the principle that small institutions are unlikely to be systemic providers of critical services,

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[7] A final report on D-SIBs is due to be presented to the G20 in November 2012.

the Government proposes that PLAC requirements should scale in line with the ring-fence buffer, with the highest (17 per cent) PLAC requirement for banks with the 3 per cent equity buffer, and no more than the prevailing minimum capital requirements for banks with no additional equity buffer at all.

PLAC requirement for UK-headquartered G-SIBs (and non-ring-fenced banks within these groups)

3.23 The Government believes, as the ICB did, that it would not be appropriate to require non-ring-fenced entities within a UK-headquartered G-SIB group to hold minimum *capital* levels above international standards (Basel III and any G-SIB surcharge), but that they should nevertheless hold up to 17 per cent PLAC against their global RWAs (subject to the exemption described in paragraphs 3.26 to 3.30).

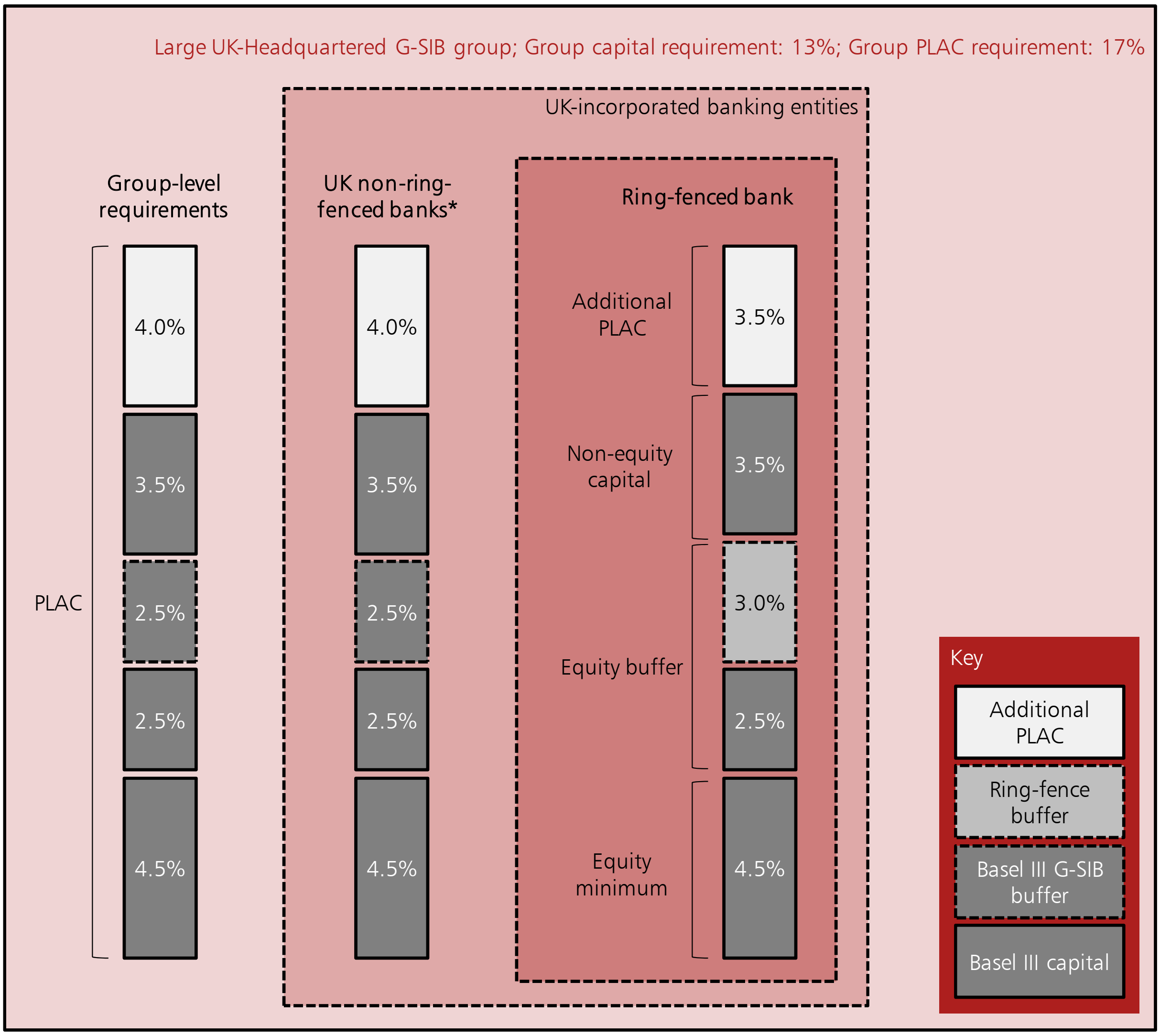
3.24 The ICB recommended that UK-headquartered G-SIBs' PLAC requirement should be scaled based on the size of their G-SIB equity surcharge, with the highest requirement for those with a 2.5 per cent (or higher) surcharge, and no additional PLAC requirement (beyond prevailing regulatory capital minima) for non-G-SIBs.[8] The Government agrees that it may be appropriate to scale PLAC requirements down for G-SIBs with a smaller equity surcharge; this would complement the intention of the G-SIB framework (where a bank's capital requirements gradually increase as they become more systemically important), and help avoid an undesirable 'cliff' in its PLAC requirement as a bank crosses the threshold into G-SIB classification. Any scaling of a G-SIB's PLAC requirement should be considered in light of Basel G-SIB assessments (due to be published in November 2012) as well as developments in the RRD.

3.25 Subject to the conditions set out below in relation to holding PLAC against RWAs held in overseas operations, the Government believes that a UK-headquartered G-SIB's PLAC requirement should be met at the level of the consolidated group and by its UK bank entities at a solo level or, if appropriate, on a sub-consolidated basis. If any of these UK entities within the group are ring-fenced banks, the higher of the ring-fence PLAC requirement or the group PLAC requirement should apply to the ring-fenced entities.[9] See Figure 3.B below for an illustration of the proposed PLAC requirement for different entities within a large UK-headquartered G-SIB that contains a large ring-fenced bank.

[8] Unless they have a ring-fenced bank(s), in which case requirements discussed in the previous section apply to the ring-fenced element(s).

[9] For clarity, this refers to the percentage requirement, not the nominal amount. All capital and PLAC requirements are percentages of the relevant entity or group's RWAs, unless otherwise stated.

Figure 3.B: Illustrative PLAC requirement[10] for a large UK-headquartered G-SIB



**It is expected that supervisors will require UK-incorporated non-ring-fenced banks within UK-headquartered G-SIB groups to meet their group PLAC requirement on a solo basis (or, if appropriate, on a sub-consolidated basis).*

3.26 The Government does not consider it appropriate that UK-headquartered G-SIBs be required to hold either equity or debt components of PLAC (beyond international or local capital standards) against RWAs held by overseas operations that do not pose a risk to UK and/or EEA financial stability. Not only would this be disproportionate, but if the UK authorities were to impose such requirements, it may risk creating a perception that the UK holds or retains responsibility for providing bail-out financial support for such overseas operations. Accordingly, the Government's view is that such requirements should not be imposed unless a strong case can be made that they are necessary.

3.27 In order for PLAC requirements to be imposed against overseas operations, then at a minimum the following conditions would have to be met:

- the scale of a firm's activities in the UK would have to be significant. Where a UK-headquartered G-SIB's combined UK operations fall beneath a de minimis level, for example if the firm holds less than £25bn of mandated deposits (as proposed for the ring-fencing de minimis), and also does not have a large non-ring-fenced bank

[10] This is not intended to be a comprehensive representation of all possible regulatory requirements.

presence in the UK, it should not be required to hold PLAC against RWAs in its overseas operations; *and*

- the failure of those operations would undermine the viability of the group's UK operations, and threaten UK and/or EEA financial stability. So, for example, the PLAC requirement would not apply to the overseas subsidiaries of UK-headquartered G-SIBs that raise the majority of their funding locally, that manage their relationships with other subsidiaries and with the parent entity effectively on an arm's length basis,[11] and that have adequate recovery and resolution plans in place.

3.28 Judgements in relation to PLAC requirements must of course be consistent with the ongoing responsibilities of the UK authorities for the consolidated group supervision of, and the coordination of group-wide resolution plans for, UK-headquartered G-SIBs. In addition, the Government proposes that all UK-headquartered G-SIBs, whether exempted from holding PLAC against overseas operations or not, should still be subject to PLAC requirements against RWAs in all UK ring-fenced banks and all UK non-ring-fenced banks.

3.29 In its December response, the Government set out its view that non-UK operations of UK-headquartered G-SIBs should be exempted from PLAC requirements (beyond international or local minimum standards) where they do not pose a risk to UK, and by extension to EEA, financial stability. Since this time progress has been made towards common European frameworks on capital requirements (CRD IV) and on recovery and resolution (RRD). In light of this, the Government recognises that it may be more appropriate to apply the overseas exemption to RWA exposures in non-EEA entities only (provided they meet the conditions set out above) – rather than differentiate between exposures in different Member States. The Government will assess the case for this approach as the European legislative framework develops.

3.30 Any PLAC requirement above a firm's regulatory capital minima should not be considered a hard minimum, breach of which would, by itself, be a resolution trigger. It would not be appropriate for a bank which dropped marginally below its PLAC requirement, but still had a large amount of equity, to be considered non-viable. Of course there should be sufficient incentives for banks not to choose to operate below the required PLAC levels as a matter of course. Therefore, as well as intervention by a bank's supervisors and an expectation that it will produce a credible plan to restore its PLAC levels, it might be appropriate for supervisors to have scope to apply restrictions on distributions, for example dividends, in the style of the capital conservation buffer, should a bank's PLAC requirement fall below the required level. Such a sanction, if applied, should not be additional to any restriction that might apply as a result of a bank operating within its capital conservation buffer; only the most onerous restriction should apply.

[11] This might be evidenced by, for example, a high degree of independence in governance structures and in funding and liquidity management.

Consultation question 12

- Should a scaling mechanism be applied to the ring-fence *buffer* and ring-fenced bank PLAC requirement, including in the context of a ring-fence *de minimis* (see Chapter 2) being applied?
- What might be appropriate *additional* metrics for assessing the resilience of UK-headquartered G-SIBs' domestic entities – both ring-fenced and non-ring-fenced – against the failure of overseas entities?

Bail-in

3.31 A statutory bail-in tool is necessary to ensure that at least some unsecured non-capital liabilities can absorb losses without having to put a bank or part of it into insolvency. During the height of the financial crisis authorities had few tools available to do this, in particular for large complex banks, and in some cases had to resort to the injection of new capital by governments. The bail-in tool is particularly important for the most systemically important institutions where the impact on the wider economy of all or part of the bank entering insolvency can be so large that it may be preferable to provide taxpayer support rather than allowing such an event to occur. Unlike other resolution tools, bail-in also could help to avoid the sale or rundown of assets that are not directly associated with critical services. The volume of these assets can be very large in systemic institutions.

3.32 By offering an alternative way – other than insolvency – to expose holders of unsecured liabilities to the costs of resolving a bank, bail-in helps to re-align risk and reward in the banking sector. This means that creditors do not obtain financial rewards without being appropriately exposed to the corresponding risks. For the bail-in tool to achieve these goals, creditors need to *believe* that they may be required to take losses when a bank fails. The Government expects that creditors would demand a higher return to compensate for the loss of the perceived implicit public subsidy.

3.33 The task of resolving large cross-border banks is complex and to ensure that UK banks are not disadvantaged relative to international competitors, it is important that the UK continues to work with other countries to design a broadly consistent bail-in tool which can work across different jurisdictions, particularly the EU, US and in Asia. G20 countries have demonstrated their commitment to a statutory bail-in tool as part of a broader resolution regime through their endorsement of the FSB *Key Attributes of Effective Resolution Regimes* in November 2011. The Government also welcomes the inclusion of a bail-in tool as part of the European Commission's proposed RRD. The Government expects the UK to implement bail-in through the transposition of this Directive.

The scope of the bail-in power

3.34 The bail-in power should have a statutory basis, with the relevant authorities determining when the trigger is met and the terms of the write-down or conversion of liabilities when the bail-in tool is used. It should not rest or depend on the inclusion of any specific clause within a debt contract. At the same time, as much transparency as possible about the process should be provided to creditors both ex ante and ex post.

3.35 In line with the FSB *Key Attributes*, the Government is of the view that the statutory bail-in power should cover a broad range of a bank's unsecured liabilities, including as necessary senior creditor claims, to ensure that there is as big a pool as possible to absorb losses. Non-equity capital instruments which bear losses no later than the 'point of non-viability' are being introduced through Basel III to increase the loss-absorbing capacity of banks but the statutory bail-in power should include a broader range of liabilities. The bail-in power should also respect the normal creditor hierarchy between creditor classes in insolvency, subject to the degree of latitude in the treatment of creditor claims within a given class already permitted under the UK's Special Resolution Regime. Under this approach there would be no need for an explicit distinction between a primary and secondary bail-in power, as recommended by the ICB. A single bail-in power that is sufficiently broad, that respects the creditor hierarchy (albeit that some liabilities may be excluded), and that may be combined with the issuance of subordinated instruments of the type discussed in paragraphs 3.39 to 3.44, could provide loss-absorbing capacity with the characteristics proposed by the ICB.

3.36 However, some liabilities may be more appropriate or straightforward to bail-in than others. The more appropriate liabilities will be those that are: (i) technically feasible to bail-in within a short period of time (authorities will need to make rapid judgements at the point of resolution); (ii) unlikely to create undesirable or unintended consequences if subject to bail-in; and (iii) able to suffer losses in insolvency. Each type of liability can be assessed against these criteria, for example:

- fully secured liabilities should not be bailed in because the creditor, in a counterfactual of insolvency, would not suffer losses. Any unsecured residual claims could however, be bailed in;
- derivatives, especially those not cleared through a Central Counterparty (CCP), could be technically challenging to bail-in in a manner that supports an orderly resolution. It may only be feasible to value them to the appropriate degree of accuracy and in the relevant timescale through rapid close-out of all relevant contracts, which ideally needs to be avoided to facilitate an orderly resolution. Furthermore, it is not easy to see how an equity conversion, as opposed to a write-down or 'hair-cut', approach would work in practice; and in some cases the value of such unsecured exposures may be modest; and
- the threat of bailing-in short-term liabilities may prompt a run on a bank, undermining attempts to restore the bank to viability.

3.37 The European Commission RRD proposals include a number of exclusions from the scope of the bail-in tool such as secured liabilities, guaranteed deposits, commercial claims relating to goods and services necessary for the daily functioning of the institution and liabilities with a maturity of less than one month. Derivatives are included within the scope of the bail-in tool, but where appropriate may be excluded by resolution authorities in order meet the overall resolution objectives. The Government will work with its European partners on the scope of the bail-in power during the course of the RRD negotiations, and is taking the opportunity in this document to seek views on these issues.

3.38 The application of the UK's statutory bail-in power to debt instruments governed by foreign law could not be guaranteed to be effective in the absence of contractual provisions specifically making the instruments subject to the statutory bail-in power. Additional work is required to determine how best to ensure debt instruments governed by foreign law could be credibly subject to the UK's statutory bail-in power.

Possible addition to the bail-in tool

3.39 As noted by the ICB, senior long term unsecured debt probably represents the most readily 'bail-inable' category of debt and one approach might therefore be to bail-in such debt before other non-capital liabilities. However, this approach would not respect the existing creditor hierarchy in insolvency unless this debt was subordinated to other senior unsecured liabilities.

3.40 A possible addition to the statutory bail-in power described above might be to require banks to make explicit in the terms of at least some long-term unsecured bonds that they were subordinate to senior unsecured liabilities in insolvency (avoiding the need for legislative subordination)[12] and that they would be bailed-in prior to senior unsecured debt and all other liabilities ranking equally with senior unsecured debt in the creditor hierarchy. In particular, and unlike contingent capital instruments, the terms of these instruments would *not* specify the terms under which a bond would be written down or converted. These and other parameters would be determined at the discretion of the resolution authority each time the power is exercised rather than being pre-specified as new contractual bail-in terms.

3.41 Such an addition would be consistent with the FSB *Key Attributes*, which require resolution authorities to apply resolution tools in a manner that respects the creditor hierarchy of claims in insolvency.[13] It would also be consistent with the proposed RRD, which notes that subordinated debt instruments could count towards the minimum requirement for eligible (bail-inable) liabilities.

3.42 It is important to note, however, that the scope of the bail-in power would *not* be restricted to this tranche of subordinated long-term debt (or indeed PLAC); rather such debt would be bailed-in before other, non-subordinated (non-capital) unsecured liabilities. This would mean that holders of these instruments could expect a higher loss given default than holders of senior unsecured liabilities. Requiring banks to issue a tranche of long-term unsecured debt that would be subordinated would be economically equivalent in bail-in to the ICB's proposal for a primary bail-in power followed by a secondary bail-in power.

3.43 The Government seeks views on the approach referred to in paragraph 3.40. In particular it seeks views on whether the efficacy of the bail-in tool, and the speed and certainty of the bail-in process, would be improved if there were a tranche of subordinated debt which the resolution authorities could quickly identify as being subject to the bail-in power before senior liabilities. The Government considers that this approach could:

- enhance market discipline because there would be greater *ex ante* clarity about the order in which instruments would be bailed-in (but this beneficial effect could be offset if the market assumed senior creditors would never be bailed in);
- reduce losses higher up the creditor hierarchy by creating a tranche of subordinated debt instruments to be affected ahead of senior creditors; and
- mitigate the risk of contagion across the financial sector if restrictions could feasibly be placed on, for example through supervision or documentation, who could buy the instruments, or the amount of these instruments that different institutions were able to own.[14]

3.44 However, it is also important to:

- consider the risks of the authorities designing specific instruments, how to promote the market in these instruments and how to respond if there turns out to be little market for them;

[12] Such arrangements are sufficient to ensure that the bonds are subordinated in insolvency.

[13] Key Attribute 3.5 states that resolution authorities should have powers to write down or convert to equity, unsecured and uninsured creditor claims to the extent necessary to absorb losses. Key Attribute 5.1 states that all resolution powers should be exercised in a way that respects the hierarchy of claims in insolvency while providing flexibility to depart from the general principle of equal (*pari passu*) treatment of creditors of the same class if necessary to contain the potential systemic impact of a firm's failure or to maximise the value for the benefit of all creditors as a whole.

[14] Potentially institutions could be required to keep a register recording holdings of these bonds, which would enable the resolution authority to identify quickly who would be impacted by virtue of an application of the statutory bail-in power to the debt.

- consider whether introducing such a layer would lead the markets to assume that senior unsecured creditors would never be bailed in and how best to convince them that such creditors were indeed at risk of being bailed-in;
- clarify whether the instrument would be better situated as an additional element of (to be treated pari passu with) existing subordinated debt that is not eligible to count towards AT1 or T2 or whether it should sit between this subordinated debt and senior unsecured liabilities; and
- explore whether it would be feasible to place restrictions on the purchase of these instruments in order to limit the potential for contagion.

PLAC composition

3.45 To meet the objectives of the statutory bail-in tool, banks need sufficient loss-absorbing capacity to enable them to be recapitalised in resolution or to absorb losses in an orderly wind-down. However, if certain liabilities were excluded from the scope of the bail-in power, there would be an incentive for banks and their investors to migrate to these liabilities.

3.46 The Government believes that PLAC should comprise the highest quality loss-absorbing instruments – that is capital (equity, AT1, T2) and long-term unsecured debt that is clearly identified as subject to the bail-in power (subject to the discussion below on whether such debt should be subordinated in order to count as PLAC).[15] It is also important to ensure that PLAC composition is consistent as far as possible with the outcomes of the RRD negotiations for a minimum requirement for eligible (bail-inable) liabilities. The proposed RRD currently provides authorities with a degree of flexibility in setting the requirements, by for example having regard to the size, business model and risk profile of the institution, amongst other criteria, but, as outlined above, the Government remains of the view that a PLAC level of 17 per cent of RWAs is appropriate for the largest UK banks. Firms can meet PLAC requirements using any eligible regulatory capital resources or sufficiently high quality bail-inable debt, whether or not the regulatory capital resources are also used to meet other capital requirements. However, the Government also takes the view that supervisors' assessments of Pillar 2 capital add-ons should be based on the CRD IV provisions and should not impinge on the choice of a bank to meet its PLAC requirement (above the regulatory capital minima) through eligible debt instruments rather than capital.

3.47 The ICB suggested that unsecured debt with at least 12 months *remaining* on its term should be eligible to count towards PLAC.[16] However, if the approach of making it explicit in the terms of some long-term unsecured bonds that they were subordinate to senior unsecured debt was adopted, one option could be to make *only* these instruments eligible to count towards the debt component of PLAC.

3.48 But, since no bank currently issues such instruments, if this approach were adopted it may be difficult for expect banks to meet their PLAC requirement until a market for them develops. There may therefore be a case for allowing other unsecured long-term debt instruments to count towards PLAC, at least during a transitional period and possibly in the longer-term. Alternatively, a phase-in period could give time for institutions to build up their PLAC requirement through the issuance of such subordinated instruments.

3.49 It is also important to provide clarity on whether subordinated debt currently in issuance that does not qualify as AT1 and T2 should be eligible to count towards PLAC. On the basis that

[15] And is unambiguously subject to the UK authorities' statutory bail-in powers.

[16] Excluding any instruments where there is any doubt about whether they are bound by the primary bail-in power, e.g. foreign law governed debt where it is not clear that the debt is subject to the bail-in power.

the proposed RRD notes that subordinated debt currently in issuance could count towards the minimum eligible requirement, the Government's provisional view is that these instruments should be eligible to count towards PLAC.

The bail-in process

3.50 The bail-in power would be additional to the resolution authority's existing statutory tools. The Government is of the view that the regulatory trigger should be the same for all resolution tools. This should be a pre-insolvency trigger, linked to the bank no longer meeting (or being unlikely to meet) the threshold conditions and there being no reasonable likelihood of remedial action being taken by or in respect of the bank to bring it back into compliance with the threshold conditions.

3.51 Bail-in would be used to recapitalise a failing bank and could be used in both an 'open bank' resolution as well as a 'closed bank' resolution. An 'open bank' bail-in is intended to enable the resolution authority to restore a bank to viability without necessarily having to transfer part of the bank's business away from the group. This tool is seen as having particular advantages in circumstances in which it is appropriate to maintain the bank or financial group 'whole' (albeit with a new business plan and new senior management as appropriate). Bailing-in debt issued by a financial holding company in the first instance (a so called 'top-down bail-in' currently being explored by the Bank of England and the Federal Deposit Insurance Corporation in the US) may be one means of undertaking an 'open bank' bail-in. In these circumstances, ring-fencing would provide additional protection for vital banking activities, by making it easier to restructure the group.

3.52 In contrast, a 'closed bank' bail-in is designed to enable losses to be imposed in the context of a restructuring of a failed bank where some (for example, any systemically important or critical services such as payment systems and a deposit book) but not all of the business of the bank is transferred to a bridge bank or a third party purchaser if appropriate. Ring-fencing would facilitate this process by making it easier to preserve the continuity of essential services.

3.53 The proposed RRD contemplates both 'open bank' and 'closed bank' bail-in models. They suggest that bail-in could be used in circumstances where the objective is to resolve the failing institution as a going concern, if this is a realistic prospect, and where systemically important services are transferred to a bridge institution.

3.54 In either case, the Government intends that the resolution authority would respect the creditor hierarchy in insolvency to the extent possible (it may be necessary to depart from the principle of equal treatment of similarly situated creditors where appropriate in order to meet the resolution objectives or to maximise the value for the benefit of all creditors as a whole). For the purposes of securing compatibility with the European Convention on Human Rights (ECHR), compensatory measures may need to be put in place in relation to the affected creditors. For example, in an 'open bank' resolution creditors could be given equity interests in the institution. In a 'closed bank' case involving a transfer to a bridge bank affected creditors could be given an economic interest in the bridge bank.

Transition arrangements

3.55 In the Government response to the ICB it was noted that the transitional arrangements (including grandfathering) would be discussed further in the light of global regulatory developments. Managing the transition period to the implementation of the statutory bail-in power is important in balancing the need to ensure that unsecured liabilities can credibly absorb losses while managing the potential effect on funding costs for the banking sector and mitigating any market distortions that the introduction of the bail-in power may introduce. For this reason it is particularly important that transitional arrangements are considered in the light of global, and in particular European, developments. The proposed RRD does not refer to grandfathering and does not require the introduction of the bail-in tool until 2018, while potentially enabling Member States to introduce bail-in alongside the rest of the proposals.

3.56 The Government's view is that some transition period is needed. This will give investors time to appropriately 'price in' the risk of the bail-in tool being used. Credit rating agencies will also need time to help them adjust their ratings methodologies to reflect the bail-in powers, and it will take time for asset managers to inform clients so they fully understand the changes and for investor mandates to adjust to accept the debt markets in this new form. Similarly banks need to be given sufficient time to manage their liabilities, to ensure that any funding cost changes can be managed smoothly. The re-structuring of legal entities within banking groups – necessitated by the implementation of ring-fencing – presents a further transition issue that is likely to impact on (at least some) existing bondholders. A transition period will allow time for banks, the authorities and investors to work through the implications for existing bank debt of banking businesses being separated out of existing legal entities.

Tax treatment of PLAC instruments

3.57 It is possible that the tax treatment of debt instruments qualifying as PLAC will be uncertain under current law. The Government intends to look into the tax treatment of these instruments, taking into account the Government's review of the tax treatment of CRD IV/CRR compliant regulatory capital instruments. If necessary, the Government will legislate, using the power in the Finance Bill 2012, which will allow it to provide tax certainty in relation to changes in financial sector regulation.

Consultation question 13

- Should particular liabilities be excluded from the bail-in tool, in particular unsecured liabilities with an original maturity of less than one month and derivatives?
- What steps could be taken to help ensure that debt issued under foreign law could be bailed-in by the UK resolution authorities if necessary?
- Would a broad statutory bail-in power give sufficient clarity to market participants to enable them to appropriately price risk?
- Would an approach of the type described in paragraph 3.40 enhance the usability of the bail-in tool?
- What steps could be taken to promote the development of a market in contractually subordinated debt to be bailed-in prior to senior unsecured debt?
- What ex ante steps could be taken to limit the risk of contagion following a bail-in?
- If the addition to the statutory bail-in tool described in paragraph 3.40 is taken forward, should there be a phase-in period to give institutions time to build up their PLAC requirement through the issuance of such subordinated instruments? Should senior unsecured debt with 12 months *remaining* on its term be permitted to count towards PLAC during a transition period and in the longer-term?
- What characteristics should existing subordinated debt that is not eligible to count towards AT1 and T2 have to be eligible to count towards PLAC?
- Under which circumstances could it be advantageous to undertake: (i) a top-down bail-in (i.e. bail-in at holding or top company level) and (ii) a subsidiary level bail-in? What are the practical implications of these alternative approaches?
- What creditor safeguards should apply to bail-in?

Depositor preference

3.58 In the December response, the Government expressed support for depositor preference, but said that further analysis was needed on whether to extend the scope beyond the ICB's recommendation that deposits eligible for protection under the financial services compensation scheme (FSCS) should be preferred debts.[17] The Government has had regard to the impact that different levels of coverage would have on achieving financial stability objectives (in particular, the effectiveness of resolution tools, including bail-in), and more widely on the differential impact that these levels might have on bank funding costs and cross-border resolvability.

3.59 The Government agrees with the ICB's conclusion that the exposure of the FSCS to losses, in the event that a bank fails, may become a potential source of contagion (as a result of the FSCS levy on surviving banks), and that should the industry be unable to meet this liability, it would become a liability for the taxpayer. Changing the creditor hierarchy, as far as permitted by EU legislation, so that deposits entitled to FSCS protection ('insured deposits') are preferred (or more specifically the FSCS standing in the shoes of insured depositors is preferred) in insolvency should sharpen the incentives for other senior unsecured creditors to exert discipline on banks' behaviour. This could help to reduce the likelihood of failure, and also give the FSCS greater protection in a failure scenario.

3.60 This means that, in a resolution scenario (for example, if a bank fails and the bail-in tool is used by resolution authorities), once capital and subordinated debt have been written down or

[17] The options of extending coverage from insured deposits to i) all retail deposits (i.e. amounts above the £85,000 FSCS limit, and also personal and SME deposits held in non-EEA branches of UK entities); and ii) all retail and corporate deposits were explored.

converted, other senior unsecured creditors would stand to take losses before the FSCS (or, if the FSCS is required to pay out, it would stand to recover more from the assets of the bank). As the loss given default of these other unsecured creditors rises, they should be incentivised to curb excessive risk taking by the bank during times of normal market conditions; and, if the bank were to be placed into resolution, the authorities can impose greater losses on these creditors.

3.61 Preferring insured deposits may also help in resolving small banks, by reducing any associated fiscal risk of using SRR powers to transfer insured deposits to a bridge bank or third party or in winding down a non-systemic institution through the bank insolvency procedure (this is because the FSCS stands to recover a greater amount of any payout it has had to make).

3.62 The Government has looked at the case for extending the classes of depositors given preference – for example, to some or all deposits not eligible for FSCS protection – to gauge whether this might mitigate any pro-cyclical effects that could potentially occur as a consequence of these other 'uninsured' depositors facing greater exposure to losses, should insured deposits be preferred.

3.63 The Government has also given consideration to the risk that a depositor preference regime which is perceived as territorial may represent a barrier to cross-border resolution for a UK-headquartered G-SIB, on the basis that overseas resolution authorities may be incentivised to ring-fence locally-based assets in order to mitigate against a perceived risk that local creditors will be disadvantaged in a UK-led resolution.

3.64 Having considered extending the coverage of depositor preference beyond insured deposits, on balance the Government considers that limiting preference to insured deposits, as the ICB recommended, would be the optimal level of coverage – this is because:

- it would best meet the Government's financial stability objectives;
- analysis and evidence submitted by banks and other stakeholders suggests that the expected costs of funding and pro-cyclical effects increase as coverage of preferred deposits increases;
- it should not have a significant impact – if any – in creating a perception that overseas creditors will be disadvantaged, as a substantial majority of insured deposits are expected to be in ring-fenced banks, which will not be able to branch outside of the EEA – only non-ring-fenced banks can do this; and
- it is the simplest form of depositor preference, both for markets and for regulators, as FSCS-coverage is easily definable and transparent. It also does not carry the same risk of arbitrage that, for example, extending coverage to include corporate deposits might (as investors may seek to re-characterise their exposures to banks as deposits).

3.65 It is important to consider whether any specific groups of senior unsecured creditors could experience adverse and disproportionate consequences as a result of depositor preference. Further analysis is required on, for example, the impact of placing insured depositors above banks' own pension fund liabilities in the creditor hierarchy (there may be a risk of large, upfront costs to banks if, as a result of the preference given to insured deposits, banks are required to reduce any pension fund deficits more quickly); or the risk to public funds or socially valuable activities that may arise if deposits placed by charities or local authorities are subordinated to FSCS claims.

3.66 As with other elements of the loss-absorbency package, the proposal to introduce preference for insured deposits is subject to ongoing developments and negotiations at the European level, particularly in relation to the proposed RRD. Subject to the outcome of the RRD negotiations,[18] including the final design of any agreed bail-in tool, the Government proposes to amend the Insolvency Act (1986) to provide that, with effect from 1 January 2019, insured deposits should be made preferred debts.

3.67 In light of possible concerns about cross-border resolvability, the Government seeks views on whether the preference proposed for insured deposits should be extended to include the equivalent sum of non-EEA deposits (i.e. the first £85,000 of deposits held in non-EEA branches of UK-incorporated entities, regardless of local insurance scheme limits).

3.68 The Government also seeks views on whether there is a case for preferring any other liabilities alongside those of the FSCS, for example deposits placed by charities and/or local authorities; and whether there are any compelling reasons why these newly preferred liabilities should not rank pari passu with *currently* preferred creditors.

Consultation question 14

- Should depositor preference be extended beyond insured deposits to include the equivalent sum of non-EEA deposits (i.e. the first £85,000 of these deposits, regardless of local insurance scheme limits)?
- Is there a case for preferring one or more groups of senior unsecured creditors alongside the FSCS, for example banks' own pension funds, or charities and/or local authorities? Are there any compelling reasons why these newly preferred creditors should not rank pari passu with currently preferred creditors?

Resolution buffer

3.69 The Government fully endorses the ICB's objective of ensuring that systemically important financial institutions have sufficient loss-absorbing capacity – including sufficient PLAC – to address any issues with their resolvability. The ICB recommended large ring-fenced banks and UK-headquartered G-SIBs may need to hold up to an additional 3 per cent of RWAs of PLAC where there are concerns about their resolvability.

3.70 Since the publication of the ICB's final report, there has been considerable progress in Europe on the legislation for regulating bank capital requirements (CRD IV/CRR). CRD IV/CRR is due to be finalised later this year and it is expected to include provision that, as is the case today, banks can be required to have additional, variable 'Pillar 2' capital requirements. The FSA already has powers under the Financial Services and Markets Act 2000 to impose such requirements, and the PRA will have similar powers to implement the CRD IV Pillar 2 requirements. No additional powers are therefore needed to allow regulators to set individual banks' capital requirements.

3.71 Furthermore, the proposed RRD includes a bail-in tool as well as provisions for a minimum requirement of 'eligible' liabilities that banks must hold – i.e. capital plus debt that can be bailed in by resolution authorities – to ensure that they are resolvable. Accordingly, the Government's position is that – subject to the outcome of the CRD IV/CRR and RRD negotiations – there is unlikely to be any need for the authorities to be given any additional, express powers in order to ensure that they are able to require UK banks to have sufficient loss-absorbing capacity to ensure that they are resolvable.

[18] The current RRD proposal would curtail the benefits that, as outlined above, Member States would seek to gain from introducing depositor preference. Negotiations are, however, ongoing.

Changes to the costs that may be covered by the industry levy

3.72 The UK has taken a leading role in shaping the international response to the crisis. It is vital to ensure that there are high global standards for financial regulation in order to minimise the risk of cross-border spillovers between financial systems and to ensure that UK firms can compete on a level playing field with the rest of the world.

3.73 The UK authorities have engaged extensively with international bodies such as the FSB, BCBS, International Organisation of Securities Commissions and the International Association of Insurance Supervisors and it is vital that it continues to do so. The representational responsibilities for doing so are spread between the FSA, the Bank of England and HM Treasury. The FSB is currently funded by the Bank for International Settlements. It is possible that at some future date it might request an increase in resources through asking its members to pay a fee. It would be appropriate to recover this modest cost from the industry. The Government therefore proposes to make amendments to the Financial Services and Markets Act (2000) to enable the successor authorities to the FSA (the PRA and the FCA) to levy the industry to pay for the costs incurred by HM Treasury in this important work.

4 Competition

Competition in the banking sector

4.1 The Government is committed to fostering a strong, diverse and competitive banking sector to ensure that the UK economy can benefit from banking products and services at efficient prices. Effective competition is also a spur to innovation and economic growth.

4.2 The Government's plans to ring-fence banking services and increase banks' capacity to absorb losses, set out in Chapters 2 and 3 of this paper, are a vital step forward in creating the right environment for competition in banking to flourish. By improving the authorities' ability to deal with the failure of financial institutions in an orderly manner, the Government is substantially reducing the perceived implicit guarantee that benefits the large incumbents.

4.3 The Government is taking forward – in addition to the competition-enhancing proposals on ring-fencing and increased loss-absorbency – a number of specific measures to further improve competition in UK banking:

- the Financial Services Authority (FSA) and the Bank of England are conducting reviews of the prudential and conduct requirements for new entrants to the banking sector. The reviews will reassess the prudential requirements of the new Prudential Regulation Authority (PRA) and the conduct requirements of the new Financial Conduct Authority (FCA) to ensure that they are proportionate and do not pose excessive barriers to entry or expansion for new entrants and prospective new entrants to the banking market. The conclusions of the reviews will be published in the autumn when the FSA and the Bank of England set out the detail of the new supervisory models for the PRA and FCA. Where possible, the FSA and the Bank of England have committed to introduce these changes in advance of the new regulatory structure;

- the Government has actively engaged with the European Commission and Lloyds Banking Group (LBG) to ensure that the forthcoming divestment of part of LBG's business results in as strong a challenger bank as possible, regardless of the final commercial arrangements LBG arrives at;

- the Government also completed a successful sale of Northern Rock plc to Virgin Money early in 2012. This was an important step forward in encouraging new entrants to the banking sector, helping to achieve the objective of a banking sector which is more diverse and better able to serve UK consumers;

- the Government has continued to hold the banking industry to account on its commitment to implement a new current account redirection service to enhance the process for individuals and small businesses who wish to switch their bank account to a new provider. To date, banks representing more than 97 per cent of the current account market have committed to being ready to launch the 7 day switching service in 2013. The service will be free to use and provide a guarantee that no customer will suffer any financial loss if any mistakes occur;

- the Government amended the Financial Services Bill, prior to introduction to Parliament on 27 January 2012, to recast the FCA's efficiency and choice operational objective as "promoting effective competition in the interests of consumers" and also retained the competition duty for the FCA. Taken together, this will mean that the FCA's competition mandate is now much stronger and more explicit, enabling it to tackle competition problems (for example, asymmetries of information, hurdles to switching or barriers to entry) swiftly and effectively;

- the Government is pleased to note that the FSA has committed to carry out a fundamental review, in early 2013, of how it can promote greater transparency in the way it and its regulated firms operate in order to better serve the interests of consumers; and

- the Government will shortly publish a consultation document setting out how it intends to reform strategy setting within the payments industry. Subject to the outcome of the consultation, the Government will bring forward legislation to create a new Payments Strategy Board to promote the development of payments systems, encourage payments systems to operate for the benefit of all users including consumers, and promote open access to payments systems for all participants.

4.4 Paragraphs 4.5 – 4.39 below set out further detail on how the Government is taking forward this package of measures.

A more diverse banking sector

Barriers to entry and prudential requirements

4.5 The ICB said that new and small banks have disproportionately high prudential requirements relative to large banks. It identified two drivers of this disparity: the difference in treatment of credit risk under the standardised and advanced approaches to risk-weighting; and additional capital requirements for credit concentration risk and governance weaknesses. In addition, the ICB highlighted that the process for setting initial capital requirements was opaque. These issues pose a potentially excessive barrier to entry or expansion for new entrants and prospective new entrants to the market.

4.6 The FSA and the Bank of England are actively considering the issues highlighted by the ICB as part of the development of both the PRA's and the FCA's approach to supervision. The intention on the prudential side is to take into account the degree to which banks can be resolved, with the aim of ensuring that if they are resolvable, the capital requirements will be lower than they would otherwise have been. This will reduce barriers to entry or expansion for new entrants and prospective new entrants to the banking market. The review is also taking into account the PRA's commitment to being transparent and accountable in achieving its objectives, as stated in the initial approach document to banking supervision. In terms of conduct, the review is considering how, consistent with its new competition objective, the FCA will ensure that authorisation and conduct of business standards are appropriate for new entrants and prospective new entrants to the banking market. In particular, the review is focussing on how the FCA will take account of the business model of potential new entrants and the proposed customer base in taking a proportionate view while still needing to be satisfied that customers will be adequately protected.

4.7 The FSA and the Bank of England will publish the conclusions of the review in the autumn and, where possible, have committed to introducing these changes in advance of the new regulatory structure.

The Lloyds Banking Group divestment

4.8 Government is strongly supportive of the ICB recommendation that the LBG divestment creates a strong challenger.

4.9 The execution of the LBG divestment is a commercial matter for LBG, but the Government has actively engaged both the European Commission and LBG to ensure that the divestment results in as strong a challenger bank as possible, regardless of the shape of the final commercial deal.

Sale of Northern Rock

4.10 The former Northern Rock was split into Northern Rock plc and Northern Rock Asset Management (NRAM) in early 2010 in order to return Northern Rock plc to the private sector and wind-down down the assets in NRAM over time. The successful sale of Northern Rock plc to Virgin Money is an important step towards normalising the Government's role in the financial sector. The sale has established a new name on the high street, and previous Northern Rock plc customers have seen an increase in the number of banking products available to them.

Improving services for consumers

Switching

4.11 The ICB recommended that a current account redirection service should be established to smooth the process for individuals and small businesses wishing to switch their bank account to a different provider, thereby driving competition in the current account market.

4.12 The banking industry has collectively committed to deliver this major new switching initiative by September 2013. The new switching service will guarantee that the switch to the new bank account will happen within 7 working days of opening the new account, be free to use for the customer, catch all credits and debits into the old (closed) account for a period of 13 months, send reminders to direct debit originators to update the details on their systems, and provide a guarantee that customers will not suffer any loss if mistakes occur.

4.13 The Government is holding the banking industry to account to meet this commitment, monitoring progress through quarterly meetings with the industry as represented by the Payments Council. To date, the Government is encouraged that current account providers covering more than 97 per cent of the current account market have committed to join this service when it launches in September 2013 (with more providers expected to join in a second tranche, expected in early 2014).

4.14 The UK's new switching service is attracting attention as an innovative development to facilitate competition in the current account market, and the Government is engaging with the European Commission on the subject. Alongside this, the Government is working with industry to make sure that the cash Individual Savings Accounts (ISAs) market works well for consumers. This includes considering how the amount of time taken to switch between cash ISA providers can be reduced.

4.15 The Government intends to monitor the switching service once it becomes operational in September 2013. The Government is clear that, if the service does not deliver the expected consumer benefits, then it will consider more radical alternatives. This will include considering further 'full account number portability'.

Competition in the Financial Conduct Authority's objectives

4.16 The FCA will be the new integrated conduct of business regulator for financial services, and will take a tougher, more proactive and more focused approach to regulating conduct in the financial services industry and markets and to securing better outcomes for consumers.

4.17 In response to the Government's white paper published in June 2010,[1] which set out draft objectives for the FCA, the ICB recommended that the 'efficiency and choice' operational objective should be replaced with an objective "to promote effective competition" in markets for financial services. It also recommended that the Government reconsider the FCA's strategic objective to provide greater clarity on competition, choice, transparency and integrity.

4.18 The Government noted these recommendations and made appropriate amendments to the Financial Services Bill which was introduced to Parliament on 27 January 2012.

4.19 The new strategic objective is framed in the Bill in terms of "ensuring that the relevant markets function well". The Government recast the FCA's 'efficiency and choice' operational objective as "promoting effective competition in the interests of consumers", and the Bill also retains the competition duty, recognising the important effect this will have in driving the FCA to seek competition-led solutions to conduct issues more generally and in pursuit of its "consumer protection" and "integrity" operational objectives. The new competition objective is complemented by a set of factors to which the regulator may have regard in deciding what constitutes effective competition.

4.20 The overall effect of these changes is that the FCA's competition mandate is now much stronger and more explicit. The revised objectives will encourage the FCA to actively promote effective competition, and provide a mandate for the FCA to take the initiative to use its powers to tackle competition problems more swiftly and effectively than the FSA did previously, for example by promoting switching, removing barriers to entry or addressing asymmetries of information.

Transparency

4.21 The ICB recommended that the Office of Fair Trading (OFT) and the FCA, once established, work with the banks to improve transparency across all retail banking products, and in particular for personal current accounts (PCAs) and business current accounts. It also made a number of specific recommendations aimed at improving the level of transparency in the UK retail banking market.

4.22 The Government sees increased transparency and financial capability as an integral part of a competitive retail banking sector. The Government's December response set out existing initiatives and work undertaken to date to improve transparency, and called on the OFT and the FSA (and the FCA once established) to work closely together to improve transparency.

4.23 Following the ICB's recommendations, the OFT and the FCA will focus on transparency as a key part of their work. The OFT has announced that it will conduct another review of the personal current account market in late 2012, following up on its 2008 market study. The review will assess levels of transparency in the market and the impact of measures already taken to improve transparency.

4.24 As part of the OFT's review of PCAs, it will take forward the ICB's recommendations on including interest foregone on bank statements and annual summaries. As a first step, the OFT will host a roundtable in October 2012 to gather views on the proposal from all relevant stakeholders.

4.25 Furthermore, the new FCA will take a proactive approach to consumer protection and will have a clear focus on the transparency of information that is available to consumers of financial services. The FCA will carry out a fundamental review of how transparency – both on the part of the regulator and by firms – will be embedded in the FCA regime and will publish a discussion paper in the first quarter of 2013. The review will consider what further measures could be introduced to improve the quantity and quality of the information that customers receive, helping them to make informed choices and exert competitive pressure on firms.

[1] *A new approach to financial regulation: judgement, focus and stability*, available at: http://www.hm-treasury.gov.uk/consult_financial_regulation.htm

4.26 A significant proportion of regulation governing transparency in financial services is introduced at the European level. This helps to ensure that UK firms are on an even footing with their European competitors and that UK consumers are equally well protected if they choose to engage with financial services providers in other Member States. The Government and the FCA will actively engage in discussions at the European level to ensure that future financial services regulation promotes transparency in the UK and across Europe.

4.27 Alongside this work, projects are already underway to further enhance competition in the market:

- *Making bank account usage data available to customers in electronic form, enabling it to be used as an input to analytical service providers and by price comparison sites.* This is being taken forward as part of the 'Midata' programme. Midata is a voluntary programme the Government is undertaking with UK businesses and industry groups to give consumers increasing access to their personal data in a portable, electronic format. Individuals will be able to use this data to make more informed choices about products and services and manage their financial affairs more efficiently.

- Requiring product ranges to include an easily comparable standardised product. The Government has tasked an independent Steering Group, chaired by Carol Sergeant, to devise a suite of simple financial products to help consumers navigate the financial services market. The aim is to increase the number of new participants in financial markets by providing straightforward, easy to understand products that are clearly identifiable as meeting 'simple product' standards. The terms of reference for the Group state that these products should: help consumers benchmark and compare other products on the market; be understandable and accessible to the mass market; not be tailored to meet individual needs, but provide consumers with confidence that a simple product will meet their basic needs and offer them a fair deal; and be a viable commercial proposition for providers. Based on the responses to the 2010 Government consultation on simple products, the Group has decided to focus initially on developing a set of simple deposit savings and protection insurance products. The Group is working with a wide range of industry providers and consumer representatives to develop proposals and deliver a report to Ministers by the end of July 2012.

- Improving price comparison tools for PCAs and creating a code of practice for comparison sites; and developing comparison tools for non-price product characteristics. The Money Advice Service (MAS) has been set up by Government to promote understanding of the financial system and raise levels of financial capability across the UK. It offers free and impartial information and advice on money matters and offers services available to all online, face-to-face or by telephone. Over the summer, MAS is upgrading its online services. As part of this, MAS will offer an online current accounts comparison tool.

Reform of the strategy-setting functions of the payments industry

4.28 The Government will shortly publish a consultation document on how best to reform strategy setting within the payments industry. This will tackle issues which have a wide-ranging impact on consumers and, taking into account the outcome of the consultation, will bring transparency and accountability to industry decision-making.

4.29 Under the present system, the Payments Council, a membership body funded by the payments industry, is responsible for the strategy of payments networks in the UK. In late 2009 the Payments Council decided that cheques would be phased out by banks and building societies from 2018. This decision caused considerable anxiety for many people in the UK, particularly those who were elderly, housebound or relied on cheques to conduct their day-to-day business (such as charities, clubs or small businesses). The Payments Council was clear that a replacement would be made available before cheques were abolished, but at the point when the Treasury Select Committee (TSC) launched an investigation into this issue in April 2011 ('The Future of Cheques'), no progress had been made to develop an alternative.

4.30 The TSC took evidence from a wide range of consumer groups, small business associations and charitable associations. They concluded that the decision to abolish cheques had caused unnecessary and unacceptable concern for customers and that the Payments Council had communicated poorly with the public. They also concluded that the predominance of banks and other payments industry members on the Council was a potential concern.

4.31 In June 2011 the Financial Secretary to the Treasury wrote to the TSC to express the Government's dissatisfaction with the way the proposed abolition of cheques was handled by the Payments Council. Following pressure from the TSC and the Government, the Government was pleased to see the Payments Council reverse its decision to abolish cheques in July 2011. In its response to the TSC report, the Government accepted the case for bringing the Payments Council within the scope of financial regulation and committed to develop options for reform.

4.32 The forthcoming consultation document will set out three options to improve the way that payments strategy is made in the UK. The Government is aiming to ensure that UK payments networks meet the current and future needs of consumers, businesses, other users and the wider economy. This means having:

- UK payments networks that operate for the benefit of all users including consumers;
- a UK payments industry that promotes and develops new and existing payment networks;
- UK payments networks that facilitate competition by permitting open access to participants or potential participants on reasonable commercial terms; and
- UK payments systems that are stable, reliable and efficient.

4.33 The first option for consultation will build on the present self-regulatory approach to UK payments strategy. It will propose a series of changes that could be carried out within the existing Payments Council to improve the way the Council delivers the Government's aims. These changes would make the Payments Council more independent and responsive to the needs and views of end users, including consumers. This option would address the immediate and essential first step recommended by the TSC of changing the composition of the Board of the Payments Council to strengthen the voice of consumers among the independent members and ensuring that any two of the four independent members could veto a decision made by the Board. This option would not increase the overall burden of regulation and would be the cheapest for the industry to deliver, but it would not bring any increased regulatory oversight to payments strategy in the UK.

4.34 The second option will propose the creation of a new public body to set strategy across the UK payments industry (the Payments Strategy Board). The Payments Strategy Board would:

- monitor, report on and make public recommendations to the payments industry;
- be composed of senior industry representatives and senior non-industry representatives (such as consumer bodies);

- be accountable to the FCA which would appoint the Board, approve the business plan and budgets and have the power to commission independent reports on its effectiveness; and
- be funded through a levy, set and collected by the FCA.

4.35 This approach aims to deliver a credible and strong strategy-setting public body which would hold the industry to account and deliver recommendations for the future direction for payments in the UK. The Payments Council – as improved by some or all of the changes proposed in option one – would be expected to play a key part in delivering the recommendations of the Payments Strategy Board.

4.36 This second option would bring payments strategy, but not the Payments Council itself, into regulation. It aims to enable the FCA to bring its new consumer and competition remits to bear on the future strategy for UK payments. The Government believes that this option strikes a good balance between ensuring that the Payments Strategy Board contains representatives from the industry, balanced by persons drawn from appropriate consumer groups and that its recommendations are public, bringing increased transparency. The Payments Strategy Board would ensure competition concerns and consumer views are fully considered when payments strategy is being formulated, at reasonable cost to business.

4.37 The third option will go considerably further and propose the introduction of a new regulator for the payments industry. The regulator would be similar to the body ('Paycom') recommended by the Cruickshank Report in 2000. It would be built on a similar model to other regulated sectors such as gas, electricity and water, with providers being licensed and the regulator enforcing licence conditions to ensure that:

- open access to payments systems was maintained;
- pricing was transparent and efficient;
- industry governance was adequate; and
- fair trading principles were respected.

4.38 A new statutory regulator for the payments industry would be a major increase in the regulatory burden with considerable costs attached and would take time to design and implement. The Government will not therefore consider this option in detail in the consultation. If the balance of consultation responses favour this option and can evidence that the benefits would outweigh the costs, the Government will then give this option further consideration.

4.39 Under all these options, the oversight regime for systemically important payment systems, operated by the Bank of England, which seeks to ensure that payments systems manage their rules and operations in a way that minimises risks to the financial stability of the financial system as a whole, would remain unchanged. Preserving financial stability will continue to be given priority in decision-making in relation to payments networks.

A Impact assessment

A.1 This section contains the impact assessment.

Title: Banking reform: delivering stability and supporting a sustainable economy **IA No:** **Lead department or agency:** HM Treasury **Other departments or agencies:** Department for Business, Innovation and Skills	**Impact Assessment (IA)** **Date:** 14/06/2012 **Stage:** Consultation **Source of intervention:** Domestic **Type of measure:** Primary legislation **Contact for enquiries:** banking.commission@hmtreasury.gsi.gov.uk

Summary: Intervention and Options

RPC Opinion: RPC Opinion Status

Cost of Preferred (or more likely) Option				
Total Net Present Value	**Business Net Present Value**	**Net cost to business per year** (EANCB on 2009 prices)	**In scope of One-In, One-Out?**	**Measure qualifies as**
£68,000m	£m	£m	No	NA

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

The financial crisis exposed many problems within the global financial system and in the way it was regulated and governed. In the years leading up to the financial crisis, regulators did not accurately identify the degree of risk in the system nor did they have the tools to deal with institutions in serious difficulty. Banks around the world had become too large and too complex, with operations spread across the globe in a host of different jurisdictions. The UK taxpayer was called upon for billions of pounds to prevent the widespread collapse of the UK financial sector. The failure of poorly regulated banks demonstrates the need for better regulation.

What are the policy objectives and the intended effects?

The policy intends to curtail the perceived implicit government guarantee that large UK banks are seen to benefit from due to being 'too big to fail' and thus help mitigate the moral hazard which may encourage banks to take on excessive risk. The policy objectives are: to make banks more resilient to shocks; to make banks more resolvable so if they fail, it is in a manner that does not threaten the provision of vital services essential to the real economy and is not costly to the Government's finances; and to curb excessive risk-taking in financial markets. Meeting these objectives will reduce the probability and severity of future financial crises, leading to greater financial stability in the UK economy.

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

Option 1: Implement none of the ICB recommendations on ring-fencing and loss absorbency, and so the Government does not implement any additional regulations to those currently in train. This option is used as the baseline to determine the costs of option 2.

Option 2: The Government's preferred approach to implementing the ICB's recommendations, having considered the analysis and evaluation completed by both the ICB and the Government. Option 2 is justified by the reduction in the probability and severity of future financial crises occurring in the UK. The benefits of the Government's preferred option far outweigh the costs incurred by the banking sector.

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

Does implementation go beyond minimum EU requirements?			Yes		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	**Micro** No	**< 20** No	**Small** No	**Medium** Yes	**Large** Yes
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:** N/A	**Non-traded:** N/A	

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister: Date: 8 June 2012

Summary: Analysis & Evidence

Policy Option 1

Description:

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 ICB's recommendations will impose no additional costs to regulations currently in train. This option is the baseline for determining the incremental cost of option 2.

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'

Implement none of the ICB recommendations on ring-fencing and loss absorbency, and so the Government does not implement any additional regulations to those currently in train. This option is the baseline for determining the incremental benefit of option 2.

There are zero incremental benefits of this option relative to the benefits of regulations currently in train.

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

Zero, for the reason given above.

Key assumptions/sensitivities/risks | **Discount rate (%)** | 3.5

BUSINESS ASSESSMENT (Option 1)

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

Summary: Analysis & Evidence

Policy Option 2

Description:

FULL ECONOMIC ASSESSMENT

Price Base Year 2010	PV Base Year 2019	Time Period Years 30	Net Benefit (Present Value (PV)) (£m)		
			Low: SEE TEXT	**High: SEE TEXT**	**Best Estimate: 68,200**

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low		5	570	**10300**
High			1370	**24700**
Best Estimate	1000-2000		770	**16600**

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

Direct implementation costs to banks of curtailing the perceived implicit government guarantee - banks will incur additional funding, ongoing operational and up-front transitional costs.
GDP impact from banks passing on increased private costs to customers through higher prices.
Direct up-front implementation and ongoing costs for the regulator (Prudential Regulation Authority)
Indirect Exchequer impact - reduced tax receipts and value impact on RBS and LBG shareholdings.

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

Indirect cost to bank customers through changes in lending and saving rates.

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	N/A	5	SEE TEXT	**36100**
High	N/A		SEE TEXT	**171300**
Best Estimate	N/A		SEE TEXT	**84800**

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 into the future. This is a benefit to the UK economy as a whole.

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. The resolution authorities will be better able to resolve banks and at a lower cost. There will be welfare benefits independent of GDP, from greater financial and economic stability due to a reduction in the probability and severity of financial crises for the UK economy. Also, curtailing the perceived implicit government guarantee would act to support low borrowing costs for the Government.

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 worst financial crisis in several generations caused unprecedented disruption in banking systems and markets around the world. It exposed many problems within the global financial system and in the way it was regulated and governed.

2. In the years leading up to the financial crisis, regulators did not accurately identify the degree of risk in the system nor did they have the tools to deal with institutions in serious difficulty. Banks around the world had become too large and too complex, with operations spread across the globe in a host of different jurisdictions. The UK taxpayer was called upon for billions of pounds to prevent the widespread collapse of the UK financial sector.

3. In response to the crisis, the Government created the Independent Commission on Banking (ICB) to investigate reforms to the banking system to deliver greater stability and competition in UK banking. The white paper entitled 'Banking reform: delivering stability and supporting a sustainable economy'[1] sets out the Coalition Government's detailed proposals for implementation of the recommendations of the ICB chaired by Sir John Vickers.

4. The objectives of the policy are:
    - First, to make banks more resilient to shocks.
    - Second, to make banks more resolvable so should they fail, for whatever reason, it is in a manner that does not threaten the provision of vital services essential to the real economy.
    - Ensuring the first two aims are met, this will curtail the perceived implicit government guarantee and curb excessive risk taking in financial markets. It must be clear that creditors reap rewards when banks do well, but take the pain if banks fail. Robust banks will then be in a position to undertake their core purpose of efficiently allocating credit to the real economy in order to secure balanced and sustainable growth.

5. Meeting these objectives will reduce the probability and severity of future financial crises and maintain Britain's place as home to world-leading banks without exposing British taxpayers to unacceptable costs if those bank fail.

Contents of the impact assessment (IA)

- <u>Scope of this IA</u>
  Details what policy options are considered in this IA, and the previous analysis of banking sector reform undertaken by the ICB.

- <u>Description of options considered</u>

- <u>Costs and benefits of options</u>
  Discusses the estimated key costs and benefits of the policy options; how the costs and benefits have been modelled; what assumptions have been made in the analysis; and the potential risks of proceeding with the lead option.

- <u>Rationale and evidence that justify the level of analysis used in the IA</u>

- <u>Wider impacts</u>
  Consideration of any other potential impacts (including those concerning equality) not presented in the costs and benefits section.

- <u>Summary of the IA and implementation plan</u>
  Sets out the stages after the publication of the white paper and IA.

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[1] The electronic version of the 'Banking reform: delivering stability and supporting a sustainable economy' white paper can be found at http://www.hm-treasury.gov.uk/fin_stability_regreform_icb.htm

Scope of the IA

ICB financial stability recommendations

6. This IA covers the Government's policies to implement the ICB's financial stability recommendations. These can be summarised under two broad headings:
   - **Ring-fencing** services whose continuity is integral to the functioning of the real economy from other functions of banks, to make it easier to preserve the continuity of those services, while managing the winding down of financial institutions in an orderly manner and without injecting taxpayer funds.

   - Increasing the **loss-absorbency** of banks, to ensure that banks are better able to absorb losses on a 'going concern' and 'gone concern' basis, to minimise the likelihood of losses falling on taxpayers. Loss-absorbency measures include a bail-in tool, higher capital requirements a minimum requirement for the best quality bail-in debt (together these constitute a bank's primary loss-absorbing capacity (PLAC)), depositor preference and a resolution buffer.

7. The details of how the Government will implement the ICB's recommendations in these areas are set out in the white paper.

Measures outside the scope of this IA

Financial stability reform options rejected by the ICB

8. In forming its recommendations on financial stability, the ICB considered a range of alternative reforms as well as those it eventually recommended. These included:
   - Full separation of retail and investment banking;
   - 'Volcker rule'[2] restrictions;
   - Contingent capital instruments ('Cocos'); and
   - Narrow and full reserve banking;

9. After 15 months of consultation and analysis, the ICB rejected these alternative reform options. The Government considers the ICB's extensive consultation and analysis of these alternative options sufficient to exclude them from further consideration. They therefore do not feature in this IA.

ICB competition recommendations

10. As well as promoting financial stability, the ICB was also tasked with making recommendations aimed at fostering greater competition in the UK banking sector. The ICB's competition recommendations included:
    - Using the Lloyds Banking Group (LBG) divestment to create an effective 'challenger' bank;
    - Ensuring that prudential requirements do not result in excessive barriers to entry for prospective new market entrants;
    - The establishment of a 'switching' service for personal and small business current accounts;
    - Requiring greater transparency over prices and charges in the retail banking market, in part by making more information available to customers;
    - Making promoting competition in UK banking a primary duty of the new the Financial Conduct Authority (FCA); and
    - A possible future market investigation reference to the competition authorities.

11. These recommendations have been accepted by the Government, and are being taken forward. However, they fall outside the scope of this IA, as they are either already implemented (FCA competition objective); industry-led (LBG divestment; account switching service); or will not result in immediate regulatory changes (possible future market investigation by competition authorities).

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[2] Section 619 of Dodd-Frank, the Volcker Rule, prohibits 'banking entities' within a universal bank from engaging in proprietary trading, or acquiring or retaining any equity, partnership, or other ownership interest in a hedge fund or private equity fund, subject to certain exemptions.

12. As described in chapter 3 of the white paper, the Government is consulting on the proposal to make amendments to the Financial Services and Markets Act (2000) to enable the Prudential Regulation Authority (PRA)[3] and the FCA (as the case may be) to levy the industry to pay for the costs of UK authorities engaging extensively with international bodies. This proposed levy is not part of the ICB's recommendations. As this proposed levy falls within the classification of a tax, it is outside the scope of this IA.

Description of options considered

'Regulatory environment' baseline

13. The Government's implementation of the ICB's recommendations is one part of a broader reform agenda. Other regulatory reforms taking place include:
    - Implementation of the Basel III Accord (through the Capital Requirements Directive (CRD) IV/ Capital Requirements Regulation (CRR)), including higher capital requirements for banks and tighter definitions of capital;
    - Introduction of a Globally Systemic Important Banks (G-SIB) capital surcharge to impose additional capital requirements on the largest and most systemically important banks;
    - Tougher liquidity requirements imposed by the Financial Services Authority (FSA); and
    - Reform of the regulatory architecture through the Financial Services Bill.

14. These reforms[4] are taking place concurrently with the Government's implementation of the ICB's recommendations. For this IA, the costs and benefits of the implementation of the ICB's recommendations are incremental to this baseline. The comparison is made of implementing the ICB against a 'regulatory environment' counterfactual future.

15. The Government has not included the European Union's (EU) developing work on bail-in[5] (within the Recovery and Resolution Directive (RRD)), in this baseline because no final agreement has been reached on the proposed rules. The costs and benefits to the UK economy of the policy option are therefore incremental to a baseline that assumes the UK is <u>not</u> subject to a statutory bail-in tool; see paragraph 33 below for a greater discussion of the cost modelling. However, it should be noted that commentators have suggested that bail-in has been priced in by UK bank funding markets to some degree.

Option 1: Do not implement the ICB recommendations

16. Option 1 involves implementing none of the ICB recommendations on ring-fencing and loss-absorbency, and so assumes no change in addition to the regulatory environment captured in the baseline. The Government therefore proceeds only with the regulatory changes detailed in the 'regulatory environment baseline'.

Option 2: Implement ICB recommendations

17. As discussed in the white paper, the Government has considered a range of different ways to calibrate the ring-fence, bail-in tool, loss-absorbency requirements and depositor preference regime in order to implement the ICB recommendations.

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[3] The formation of the PRA is currently being confirmed in the Financial Services Bill. It is expected to be operating in 2013 to partly replace the functions of the FSA.

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

[5] For more details on the EU's RRD, please see http://ec.europa.eu/internal_market/bank/docs/crisis-management/2012_eu_framework/COM_2012_280_en.pdf.

18. The detailed policy measures being taken forward are set out in the white paper along with areas for consultation. Assembling the whole ICB implementation package involved decisions on a number of individual policy variables, including:

- Definitions of mandated/prohibited services;
- Geographical restrictions of the ring-fence;
- Funding restrictions for ring-fenced banks;
- Ownership, governance and disclosure requirements for ring-fenced banks;
- De minimis exemption from ring-fencing for small banks;
- Calibration of capital requirements for ring-fenced and non-ring-fenced banks;
- Design of the bail-in tool;
- Calibration of debt components of PLAC; and
- Design of depositor preference regime.

19. For each of these policy variables, the Government considered a number of different calibrations. The different estimated impacts of calibrations for each variable are discussed in the section 'modelling the private costs to banks' below.

20. Policy option 2 is the Government's chosen policy for implementing the ICB's financial stability recommendations. The white paper has detailed information of the policy variables that make up the lead policy option. Below is a summary of the policy variables that comprise the lead policy option for the purposes of the cost-benefit modelling in this IA:[6]

Ring-fencing:

- Ring-fenced banks will be separate legal entities from non-ring-fenced banks;
- Mandate that small and medium-sized enterprises (SMEs) and retail deposits, and consequently overdrafts, can only be held within a ring-fenced bank;
- Prohibit trading and investment banking activities that impede resolution and/or increase a ring-fenced bank's exposure to shocks from financial markets;
- Permitting the ring-fenced bank to provide 'simple' derivative products to clients;
- De minimis exemption for small UK banks and an exemption for all building societies from ring-fencing requirements;
- Relations between the ring-fenced bank and the rest of the group should be arm's length and carried out on a third party basis;
- Exposures to financial institutions will be prohibited; and
- Deposits from high net-worth individuals (HNWI) will be exempted from being mandated in the ring-fence, and so those individuals may bank with non-ring-fenced banks if they so choose.

Loss-absorbency:

- A leverage ratio for all banks in line with international standards, assumed to be 3 per cent;
- The largest UK ring-fenced banks and the largest UK building societies should hold an equity 'ring-fence buffer', bringing their minimum equity capital requirements to at least 10 per cent of risk-weighted assets (RWAs);
- A power to bail-in unsecured liabilities, including a tranche of subordinated debt prior to other unsecured liabilities;
- A 17 per cent level of PLAC for the largest firms;
- Exemption from the PLAC requirement for those overseas operations of UK-headquartered G-SIBs that do not pose a risk to EEA financial stability; and
- Preferring 'insured deposits' (i.e. those protected by the Financial Services Compensation Scheme (FSCS)).[7]

21. After extensive consultation, the Government believes that this combination of policy variables will deliver the greatest net benefit to the UK economy and so is the Government's lead policy option.

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[6] This is not an exhaustive list of all the policy variables that make up the lead policy option. The policy variables listed here are those that are likely to have a significant impact on the cost of potential policy options. Some of these policy variables are up for consultation in the white paper, so for the purposes of the IA the Government has taken the lead option in each case. Further details of all the policy variables are provided in the white paper.

[7] See http://www.fscs.org.uk/ for more details of the scheme.

The white paper sets out the Government's decision on each of these policy variables and parts of the package that are being consulted on.

Costs and benefits of options

Table 1: A summary of the costs and benefits of each policy option.

Policy 1: Do not implement ICB recommendations
There are **zero** costs of this policy option There are **zero** benefits of this policy option
Policy 2: Implement ICB recommendations
<u>Monetised costs</u> Annual total private cost to UK banks: £4bn – £7bn Annual GDP cost: £0.6bn - £1.4bn **PV GDP cost**: £10bn – £25bn Annual tax receipts: £200m – £500m Value loss of the Government's shareholdings in Royal Bank of Scotland (RBS) and Lloyds Banking Group (LBG): £6bn - £9bn **<u>Monetised benefits</u>** Annual GDP benefit: £2bn – £9.5bn **PV GDP benefit**: £36.1bn – £171.3bn **<u>Non-monetised benefits</u>** Ring-fencing of banks will protect vital banking services from shocks elsewhere in the financial system and reduce the risk of contagion. Ring-fencing and bail-in will make the resolution process for banks more straightforward and less costly for the Government. A more credible resolution tool will then curb incentives for excessive risk taking, by curtailing the perceived implicit government guarantee. A curtailment of the perceived implicit government guarantee would lead to a reduction in the perceived riskiness of UK government debt, supporting low borrowing costs.

22. All estimates in the table above are gross estimates and are incremental to the 'regulatory environment' baseline set out in paragraph 13.

23. Option 1 has **zero** costs and **zero** benefits incremental to the 'regulatory environment' baseline as it assumes the Government does not implement the ICB recommendations and so no change in the regulatory environment. Therefore, the next section details the costs and benefits of the Government's <u>lead policy option</u> (policy option 2), along with a discussion of the assumptions, sensitivities and risks.

Costs of option 2: Government's lead option

24. This section details the Government's modelling of the costs of implementing the ICB's recommendations and is split into three sections:
    - Private costs to banks
    - Impact on GDP
    - Impact on the Exchequer

25. Each section describes how the costs arise; how the costs have been modelled; and the assumptions, sensitivities and risks that have been considered in the modelling.

Private costs, GDP impact and Exchequer impact

26. The overall gross cost of the policy option stems from the additional private costs incurred by banks. These additional private costs lead to a gross reduction in GDP and a gross reduction in Exchequer revenues. The following sections discuss the costs to the banks, to GDP and to the Exchequer:

Private costs to banks

How the costs arise

27. The Government estimates that the total private cost to UK banks of the lead option for ICB implementation will be in the range **£4bn - £7bn per year**, with one-off transitional costs of around £2.5bn.

28. Implementing the ICB will lead to an increase in the private costs to large UK banks through a curtailment of the perceived implicit government guarantee and the structural split of these banks.

<u>Curtailment of the perceived implicit government guarantee</u>

29. To the extent that investors believe the Government would not let a large bank fail, it benefits from a perceived implicit guarantee. This acts to lower the cost of funding for large UK banks as investors believe that the probability of losses occurring, and the extent of any losses, is lower than if they perceive there to be no implicit guarantee. Academic evidence suggests that the value of this guarantee is between £6bn and £100bn.[8]

30. Some progress has been made in curtailing the perceived implicit guarantee; it can be argued that the implementation of the Special Resolution Regime (SRR) 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 of the extent to which this has already been priced in by the market. Implementation of the ICB recommendations will curtail the perceived implicit government guarantee, by making banks more resilient and resolvable.

31. As the perception of an implicit government guarantee is reduced, bank funding costs would be expected to rise as more risk falls on investors and not on the Government and taxpayers.

<u>Structural split</u>

32. Banks may face a loss of diversification in the long term as banks will no longer be able to cross-subsidise or cross-sell services between the ring-fenced and non-ring-fenced bank. There will also be upfront transitional costs (such as establishing new subsidiaries) and ongoing costs of operating two entities rather than one (such as operating separate IT platforms).

Modelling the private costs to banks

33. To estimate the private costs to UK banks of ICB implementation, the Government commissioned extensive scenario modelling from the large UK banks. The banks were asked to model their future balance sheets, first under the assumptions made for the 'regulatory environment' baseline and then

[8] 'The Implicit Subsidy of Banks', May 2012, Financial Stability Paper 15, Bank of England.

under a range of scenarios for ICB implementation. These scenarios included different potential calibrations of ring-fence design, the bail-in power, and the different options for depositor preference.

34. On the basis of this modelling, the Government was able to estimate the aggregate quantities of additional capital required, and the aggregate changes in banks' requirements for different types of wholesale funding, for a range of ICB implementation scenarios. Applying assumptions for the annual costs of capital and funding (based on historical data and information supplied by UK banks) produced annual capital and funding costs of ICB implementation. The large UK banks were also asked to estimate the transitional and ongoing operational costs of complying with the ICB's recommendations. A fuller discussion of the assumptions made and the sensitivity of the modelling results to those assumptions is in paragraph 41 below.

35. A sample of smaller UK banks was asked to follow a similar, simplified approach to that above. In addition to these results, the FSA also supplied confidential analysis of the impact on small UK banks of implementing the ICB recommendations.

36. Aggregating these modelling results, **the Government estimates the total private costs to UK banks of the lead option for ICB implementation will be in the range £4bn - £7bn per annum, with total one-off transitional costs of around £2.5bn**.

Impact of alternative policy calibrations

37. As discussed above, the Government considered a range of different calibrations for the ring-fence and loss-absorbency requirements in implementing the ICB recommendations. The estimated additional cost of alternative policy calibrations on the overall cost of ICB implementation are set out in the table below:

Table 2: The incremental costs of alternative policy calibrations.

Alternative calibration	**Additional cost of policy variable (per annum)[9]**
RING-FENCE	
Mandated and prohibited services	
Mandating individual/SME credit in the ring-fenced bank	£50m
Prohibiting ring-fenced banks from selling any derivatives	£100m
Allowing ring-fenced banks to sell a full range of derivative products to SME clients only	£50m
Allowing ring-fenced banks to hold non-EEA assets	£50m
Relaxing restrictions on ring-fenced banks intra-group funding	£50m
De minimis	
Not granting a de minimis exemption and requiring all banks to ring-fence regardless of size/systemic importance	£300m - £500m
LOSS-ABSORBENCY	
Capital requirements:	
Increasing the leverage ratio up to 4.06 per cent for large ring-fenced banks	£700m - £1.3bn
Bail-in tool:	
Statutory bail-in tool with no contractually subordinated tranche of debt to be bailed in before senior unsecured liabilities	£100m -125m
Depositor preference:	
Preferring all retail deposits	£475m - £500m
Preferring all deposits	£800m - £850m

[9] Costs expressed here are rounded to the nearest £25m

38. For the ‘mandated and prohibited services’ part of the ring-fence design, the banks adapted the asset and liability structures of their balance sheets under different scenarios to estimate the impact on capital and funding requirements. The costs of not having a de minimis exemption in the policy option was calculated by using estimates of the costs provided by small banks in the UK, and from confidential data supplied by the FSA.

39. For loss-absorbency, the costs of increasing the leverage ratio were determined from the balance sheet modelling undertaken by the banks. The costs of the bail-in tool and depositor preference were determined using the modelling of the large UK banks of how the quantity and price of wholesale debt would change under different loss-absorbency scenarios. The banks’ estimates were used in conjunction with external estimates of the cost impact on wholesale debt.

40. It is important to note that the impact of alternative calibrations have been estimated in isolation, i.e. holding the rest of the overall package constant. As the different elements of the package interact, it is not necessarily possible to sum the impacts of a number of individual alternatives on the overall cost of the ICB implementation package in order to derive an overall cost for an alternative package.

Assumptions, risks and sensitivities

Static modelling of bank balance sheets

41. The modelling of bank’s balance sheets was static, i.e. took no account of potential behavioural responses by either banks’ 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 (e.g. sufficient capital to ensure a bank could attain a high enough credit rating in order to operate effectively in the market).

42. In practice, there may be more extensive behavioural responses by banks (adjusting their business lines post-split) and customers (switching their banks accounts between ring-fence and non-ring-fence banks). These behavioural responses are impossible to quantify with confidence. The behavioural effects from customers are likely to be particularly important for ring-fence design: there is a risk that customers who are prevented by the ring-fence from purchasing derivative products from a ring-fenced bank will switch their other banking business (potentially including loans and deposits) to another bank. Management responses are particularly important for small banks; in the absence of a de minimis exemption, ring-fencing may make small banks’ entire business models unviable; such banks may choose not to continue operating with additional costs, but instead to exit the market.

43. The balance sheets estimated by the banks are also based on the banks’ own assumptions about performance of their business in years ahead.

Cost and availability of capital

44. Cost estimates are based on an assumed range for the annual cost of equity of 8 per cent - 16 per cent. These figures have been chosen as a range around a long-run historical average cost of equity[10] to banks of 11.5 per cent, used by the FSA.[11]

45. It has also been assumed that the additional capital required to comply with ICB implementation is available to banks. The Government estimates that the total amount of extra equity required by UK banks as a result of ICB implementation is approximately £19bn. An illustrative calculation suggests that UK banks will have substantial capacity to raise additional equity through retained earnings. According to their published accounts the major UK banks currently have collective equity of around £250bn. If they could achieve an annual return on this equity of 10 per cent, and if they distributed half of that return to shareholders, they would be able to grow their equity at a rate of 5 per cent per annum. Over a period of 6 years, this would allow them collectively to raise an additional £85bn of

[10] Rather than the opportunity cost of equity over debt.

[11] ‘Strengthening Capital Standards 3 - further consultation on CRD3’, FSA consultation paper CP11/09

equity. If the proportion of returns that was retained were increased to 70 per cent, banks could raise £125bn of new equity through retained earnings.

Wholesale funding cost assumptions

46. The impact of the lead policy option on banks' funding costs is difficult to forecast precisely. There are many factors around the ring-fence split and loss-absorbency that will impact, both positively and negatively, the cost of wholesale funding for banks. The Government has considered estimates from the banks' modelling and external estimates[12] of the potential impact of implementation of the ICB's recommendations on the price of wholesale funding. For the purposes of this IA, the Government has made the following assumptions for the change in the price of wholesale debt, relative to the 'regulatory environment' baseline:
    - Ring-fencing: for ring-fenced banks, a change of between -10 basis points (bps) and 0bps; for non-ring-fenced banks, a change of between 0bps and 75bps.
    - Bail-in: for ring-fenced banks and non-ring-fenced banks, a change of between 0bps and 200bps. The range reflects uncertainty regarding the extent to which bail-in has been priced into the baseline.
    - Depositor preference: for ring-fenced banks, an increase of between 25bps and 50bps; no change assumed for non-ring-fenced banks.

47. The theoretical arguments suggest the costs of funding for different debt classes may increase or decrease. For example, a ring-fenced bank may see lower costs of funding than a pre-ICB universal bank, if market investors believe this part is now safer. Bail-in ought to see the price of unsecured liabilities subject to the bail-in power increase. Bail-in, in which a tranche of non-capital subordinated debt is identified in contract as being bailed in before other senior unsecured debt, could also lead to a decrease in the price of unsecured liabilities that now ranked higher in the creditor hierarchy than this non-capital subordinated debt.

48. The Government has made various assumptions regarding the estimated change in the cost of wholesale funding as a result of implementing a bail-in power within the policy option. The modelling assumptions for the bail-in power are as follows:
    - The Government has assumed there is no impact of bail-in within the regulatory environment baseline, so that the incremental costs of implementing the ICB capture the full cost of a bail-in tool.
    - The incremental cost of implementing the ICB is not relative to today's prices, but to a future non-ICB counterfactual (see paragraph 13 above), in which there would be no bail-in tool.
    - Market investors are likely to have begun pricing the future impact of bail-in into the cost of UK bank debt today. This is because investors likely anticipate some form of bail-in type outcome in the event of a bank failing, in part as a result of the provisions of the UK's SRR. To the extent that markets already price in bail-in, this means a portion of the bail-in cost has already been paid.
    - There is a case for including bail-in in the baseline as it is part of the RRD proposals, and so likely to be introduced in the EU. For the purposes of this IA, however, it has been decided to ascribe the full cost of bail-in to the ICB as it is a key part of the ICB package, and because the EU proposals are not yet finalised. The Government does expect bail-in to be implemented through the RRD.

49. Also, as mentioned before, the Government has undertaken static modelling of banks' balance sheets to determine the change in funding costs. Cost minimisation by the banks through balance sheet changes has not been factored into the modelling.

Regulatory discretionary tools

50. For the purposes of the Government's modelling, the overall cost of the lead option for ICB implementation has assumed that no resolution buffer is imposed on any UK banks, and that UK-

[12] Including, for example, "Investor Views on Bail-In Senior and Subordinated Debt" JP Morgan 2010;
"Bond spreads, WACC and the economic break-even point", BNP Equity Research 2012;
"Depositor Preference Is the Real Threat − Not Encumbrance", Morgan Stanley Research 2012

headquartered G-SIBs are required to hold PLAC against their UK assets only. As set out in the white paper, these elements of ICB implementation may be subject to a degree of regulatory discretion.

Operational costs

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

52. 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 removing the ring-fenced banks from their VAT groups. The Government is continuing to consult with industry to determine the extent of these possible costs and ways in which to mitigate them (see white paper chapter 2). For the purposes of this IA, these costs have been excluded.

Transitional costs

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

54. The lead policy option includes removing the joint and several liability for pension liabilities between the ring-fenced and non-ring-fenced bank. Requiring the banks to split their pension liabilities could impose a cost if trustees demand higher contributions from their bank based on the belief that the split of their bank's pension scheme will impact their bank's ability to fund either or both of the resulting schemes. As set out in the white paper, the Government intends to mitigate this cost by requiring the removal of the joint and several liability by potentially around 2025. For the purposes of this IA, these costs have been excluded.

Crisis response and stress

55. The modelling for this IA has not considered quantitatively how the cost of funding may change 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, is subjective and highly sensitive to assumptions.

56. In theory, the effect of the ICB recommendations in a stress is complex and will vary from bank to bank depending on investor perception. Implementing the ICB recommendations is likely to exaggerate the movement of funds from higher risk banks to lower risk banks, as investors perceive there to be a curtailment of an implicit government guarantee. Curtailing the perceived guarantee ought to promote a more efficient pricing of debt in a stress scenario, which would act to reduce the cost of funding for lower risk banks.

57. The Government believes ICB implementation should reduce the extent to which the price of debt increases in a stress scenario, as individual banks, and the banking sector as a whole, are more resilient to stress. The ring-fencing of banks is likely to reduce contagion in the industry in a stress scenario.

58. The Government acknowledges that the costs of bank funding will change in a stress scenario but is of the view that there are too many uncertainties to model meaningfully how implementing the policy option will impact the cost of funding in a stress scenario.

Impact on GDP

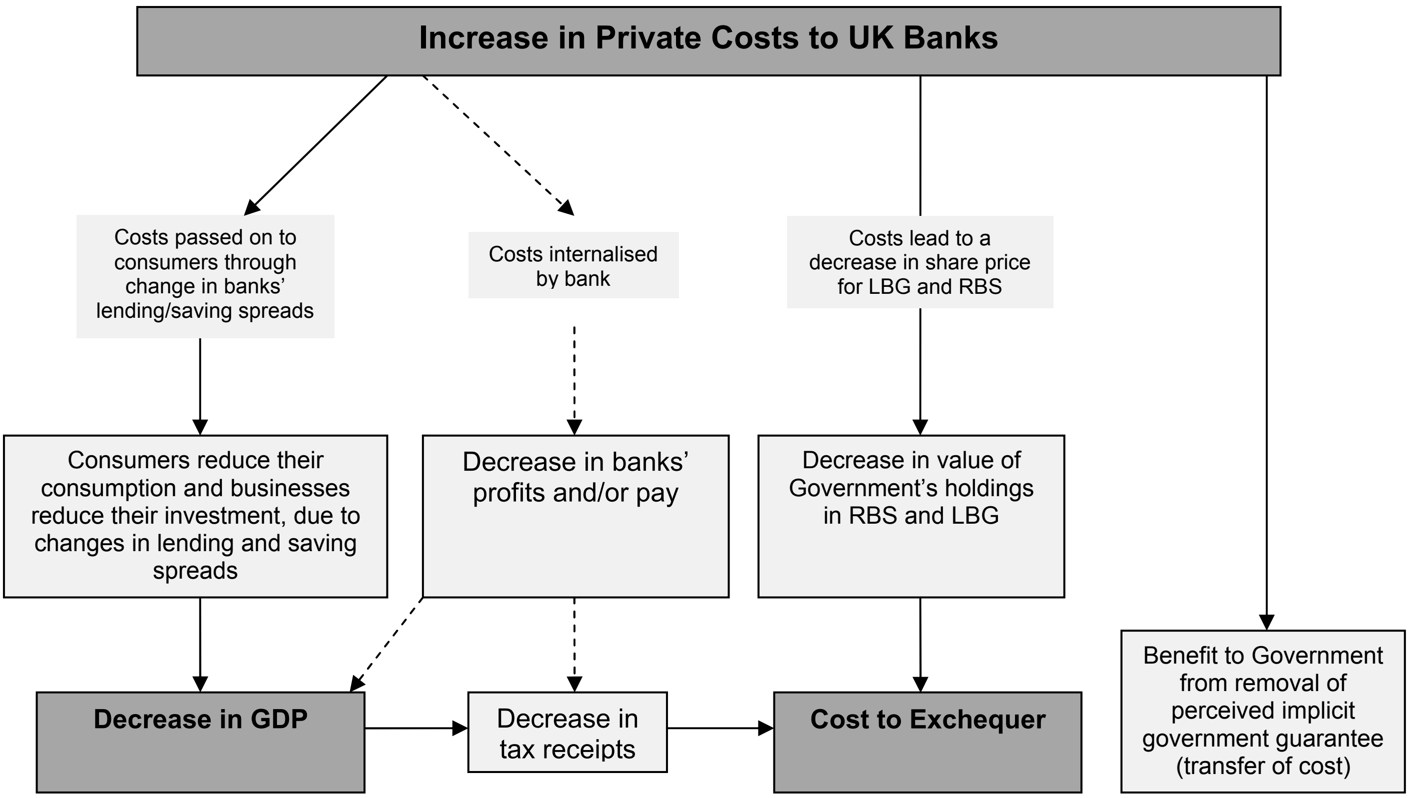
59. The increase in banks' private costs is estimated to produce a gross reduction in GDP (i.e. without taking into consideration the benefits to GDP) of **£0.6bn-£1.4bn per year** relative to the 'regulatory environment' baseline scenario. The present value cost to GDP is estimated to be £10bn-£25bn.

How the GDP cost arises

60. A substantial proportion of the private costs to banks will be the result of the curtailment of the perceived implicit government guarantee for banks that are seen as ‘too big to fail’. The ICB estimated that around half of the private costs to banks were due to the removal of this guarantee. Removing this subsidy would transfer costs to banks that are currently being borne by the Government in the form of contingent liabilities that may crystallise in the event of the Government bailing out a failing bank. Transferring this cost from Government to banks should therefore have no impact on the economy overall. Hence the social cost (i.e. the cost to GDP) of ICB implementation is expected to be lower than the private cost to banks.

61. GDP costs arise as higher private costs to banks are passed on to bank shareholders (in lower returns), employees (in lower pay) or customers (through prices). Depending on how higher costs are passed on, there would be an impact on consumption and investment in the economy, and hence on GDP.

62. How private costs to banks could feed through into the wider economy and to the Exchequer is summarised in the schematic diagram below:



63. Note, as mentioned above, part of the total private costs to banks do not pass through to GDP as there is a transfer of cost from the Government to banks of the curtailment of the perceived implicit Government guarantee.

Modelling the GDP costs

64. Having estimated the aggregate private cost to UK banks of ICB implementation, the Government then estimated the impact of these costs on GDP using modelling by the FSA using the NiGEM model.[13] NiGEM is an empirically-based econometric model that estimates the impact on credit prices and economic output as a result of changes to banks’ minimum capital ratios, funding and operational costs. The model is based uses long-run historical data to determine the impact of changes in bank costs on the wider economy.

[13] The NiGEM model is a macroeconometric model created by the National Institute of Economic and Social Research (NIESR). See Appendix 1 of the FSA’s Occasional Paper 38 (http://www.fsa.gov.uk/pubs/occpapers/op38.pdf) and Occasional Paper 42 (http://www.fsa.gov.uk/static/pubs/occpapers/op42.pdf), for more details of the FSA’s modelling with NiGEM.

Assumptions, risks and sensitivities

NiGEM modelling of long run GDP cost

65. The NiGEM model calculates the cost to GDP on the basis that banks pass on to consumers near to 100 per cent of the increase in costs incurred by them. This assumption is based upon the historical evidence that underpins the modelling of NiGEM. If this assumption is made, then it suggests that little, if any, costs directly impact banks' profits, in the first instance. 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.

Time profile of additional bank private costs

66. The Government has made 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; and
    - the capital and funding costs increase over the transition period until reaching the point at which banks hold sufficient capital and debt to meet the policy requirements. At this point, the capital and funding costs are constant, ongoing costs.

67. Banks will have to be compliant of the requirements by 2019.

Present value calculations

68. For the present value calculations, the costs and benefits have been assumed to persist for 30 years, discounted according to HM Treasury's Green Book guidance.[14] However, the Government's intention is for the implementation of the ICB recommendations to be a permanent reform to the banking sector. 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. The 30-year time period has been selected solely to show an illustrative present value calculation.

Short-run GDP impact

69. In the long run, by making banking regulation more stable and curtailing the perceived implicit government guarantee, implementing the ICB recommendations is 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 by shrinking their balance sheets and cutting back on lending to the real economy. External estimates suggest that there is a cost to GDP when banks are required to increase capital requirements in a short period of time.[15]

70. To mitigate this risk, the Government is allowing banks an extended period of time to comply with the regulations (full compliance is necessary by 2019, as per the ICB recommended timetable). The Government has carefully weighted the impact of different elements of the ICB package to mitigate the short term risk, for example by preferring a leverage ratio in line with international standards, rather than the 4.06 per cent level recommended by the ICB. In addition, the Government has implemented policies (such as the National Loan Guarantee Scheme) [16] to ease the flow of credit to businesses and individuals, therefore mitigating further these short term risks.

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[14] HM Treasury Green Book: http://www.hm-treasury.gov.uk/data_greenbook_index.htm.

[15] For example, "*Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements*", Basel Committee on Banking Supervision, December 2010.

[16] More information on the National Loan Guarantee Scheme can be found at: http://www.hm-treasury.gov.uk/nlgs.htm.

Impact on the Exchequer

71. Implementing the ICB recommendations is estimated to produce a gross reduction in tax receipts of £200m-£500m per year and a reduction in the value of the Government's shareholdings in partially publicly-owned banks of £6bn-£9bn, relative to the 'regulatory environment' baseline.

Modelling the impact on the Exchequer

72. The gross cost impact to the Exchequer is expected to come via two channels. Lower GDP relative to the baseline should impact negatively on ongoing annual tax receipts, all else being equal. In addition, higher private costs to banks are expected to push down on the market value of bank shares, including those of partially publicly-owned banks such as RBS and LBG.[17] Relative to the baseline, therefore, there is likely to be a one-off value loss to the Exchequer from the Government's bank shareholdings.

<u>Impact on tax receipt</u>

73. Having calculated the impact on GDP, the gross decrease in ongoing annual tax receipts is estimated to be £200m-£500m. This figure has been calculated using the long-run tax receipts/GDP ratio for the UK of 35.2 per cent.

<u>Impact on the Government's shareholdings in RBS and LBG</u>

74. The additional costs of ICB implementation are likely to impact on the value of the Government's stakes in RBS and LBG, 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 ICB implementation 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.

75. The Government has used estimates provided by UKFI to assess the potential loss to the value of its shareholdings arising from the ICB recommendations. These estimates are based on 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 things), 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 LBG. Rather, the estimated loss attributable to ICB implementation is relative to the counterfactual future scenario in which the ICB recommendations are not implemented (consistent with other cost and benefit estimates in this IA). With markets anticipating ICB implementation, it is likely that the impact is already largely or entirely factored into the two banks' current market share prices.

76. On the basis of these assumptions, and subject to the caveats set out below in paragraph 80, it is estimated that implementing the ICB recommendations would lead to a relative reduction in the value of the Government's combined shareholdings in RBS and LBG of around £6bn to £9bn.

<u>Assumptions, risks and sensitivities</u>

Tax receipts

77. As noted in the 'impact on GDP' section, the NiGEM model passes on near to 100 per cent of the increase in costs incurred by banks onto consumers. Therefore, the impact on tax receipts is assumed to arise entirely through changes in lending and saving spreads that decrease consumption and investment, lowering GDP. However, it may be the case that banks internalise some of these costs incurred, which would subsequently put downward pressure on their profits. A decrease in profits would then lead to a decrease in corporation tax. Similarly, should banks pass the costs on to employees through cuts in incomes, this will reduce tax receipts.

78. However, it is hard to ascertain (without further extensive analysis) whether there would be a marked difference to total tax receipts if banks did internalise a certain fraction of the costs. The

[17] The shareholdings of RBS and Lloyds as at 1 May 2012 were 82% and Lloyds 39.8% respectively.

extent to which banks absorb the private costs of ICB implementation is a commercial decision for each bank, and so cannot be forecast with certainty by the Government.

79. Also, there is an ambiguous impact on tax receipts from an increase in funding costs. There is a potential loss of tax receipts if banks can deduct higher funding costs but, conversely, higher returns for the investors may lead to an increase in tax receipts.

Government's shareholding in RBS and LBG

80. UKFI's estimates of the value impact are subject to a range of caveats. In particular, consistent with the approach taken elsewhere in this IA, the modelling does not take account of any potential management responses to offset the higher costs imposed by implementation of the ICB (e.g. reconfiguring business lines) or the potential behavioural responses by bank 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 ICB implementation 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.

81. As noted above, the loss is not relative to the current market value of the Government's shareholdings in RBS and LBG. Rather, the estimated loss attributable to ICB implementation is relative to the counterfactual future scenario in which the ICB recommendations are not implemented.

Benefits of option 2: Government's lead option

Summary of benefits

82. The Government estimates implementing the ICB recommendations may lead to an increase in GDP of **£9.5bn per annum**. The following sections detail how the benefits accrue and the modelling and analysis of the benefits.

How the benefits accrue

83. The key benefit of ICB implementation will be greater financial stability, which will result in a higher level of expected and average GDP in the future. By curtailing the perceived implicit government guarantee that large UK banks benefit from, ICB implementation will help mitigate the 'moral hazard' of banks taking excessive risks, which is fuelled by market perception that the Government will have to bail them out should they fail. Banks' wholesale creditors will now have a greater incentive to discipline management against excessive risk-taking, as there will be a credible tool in place to make them bear losses in resolution.

84. A more effective resolution tool, including bail-in, will ensure that losses fall on creditors in the event of a bank failure. Implementing a ring-fence will protect vital banking services from shocks elsewhere in the financial system and reduce the risk of contagion. Also, separating banks into ring-fenced and non-ring-fenced entities will make the resolution process for banks more straightforward, thus reducing the likelihood and scale of calls on public funds when banks do fail.

85. ICB implementation will reduce the probability and severity of future financial crises and thus lead to greater financial stability and a higher level of future GDP. Individuals and business will also benefit from an increase in welfare from a more stable path of GDP, which in turn increases confidence in the economy and provides a better environment for investment.

86. Furthermore, curtailing the perceived government guarantee should bring a benefit to the Government's cost of borrowing, as investors should recognise there to be a reduction in sovereign risk, as a result of a lower contingent liability to the banking sector. This reduction in sovereign risk should help support low sovereign borrowing costs. A recent announcement by Moody's credit rating agency show how the perceived implicit government guarantee for large UK banks has reduced.[18]

[18] http://www.moodys.com/research/Moodys-downgrades-12-UK-financial-institutions-concluding-review-of-systemic--PR_227067.

Modelling the benefits

87. The modelling of the benefits is based on the extent to which the policy reduces the probability and expected cost of future financial crises. Estimating the probability and cost of future financial crises is complex, and academic estimates vary widely. The range of academic estimates of the impact of historical financial crises is very large. The Basel Committee on Banking Supervision (BCBS) collated academic estimates for the costs to GDP and probability of historical financial crises.[19]

88. The range of estimates for the net-present cost to GDP ranges from 16 per cent – 302 per cent of GDP in the year the crisis hits. The range is very wide as it incorporates financial crises with both permanent (scarring) effects and non-permanent effects.[20] The range of probabilities of financial crisis occurring in a given year, ranges from 3.5 per cent - 5.2 per cent (between every 19 and 28.5 years).

89. Therefore, the range for the annual cost of financial crises for the UK economy is very substantial, between 0.56 per cent and 15.7 per cent. In terms of the cost to the economy per annum (using 2010 GDP), the range is estimated to be between £8.5bn and £231bn per annum.[21] The ICB used the same research as the basis for its annual cost calculation of £40bn per annum (assuming a probability of 4.5 per cent and a cost to GDP of 63 per cent). The ICB argued therefore that its recommendations would deliver net benefits if it reduced the severity of future financial crises by between only 1/40th and 1/13th.

Assumptions, sensitivities and risks

90. The principal assumptions are those relating to the benefits of avoiding financial crises (see key benefits above). Financial crises are very costly and so the cost of financial instability is very high. As noted previously, the estimates of the cost of financial crises and therefore the benefits of greater stability vary greatly. However, the Government believes that the lead policy option will deliver significant benefits to the UK economy.

Illustrative calculation

91. The illustrative calculation of the benefit of the policy option has been produced using the ICB cost of financial crises estimate of £40bn per annum. If it is assumed that implementation of the regulatory changes in train (i.e. those captured in the baseline), reduces the probability of financial crises by 30 per cent and that ICB implementation, incremental to this baseline, reduces the probability of financial crises by a further 10 per cent and the cost to GDP of a crisis by 25 per cent, then the policy option would reduce the cost of future financial crises to the UK economy by £9.5bn per annum.

Sensitivity analysis of estimated benefits

92. An alternative approach would be to assume that the current regulatory environment and ICB implementation have a lower impact on reducing the impact of financial crises on UK GDP; for example, assuming the policy impact (and the current regulatory environment) has half the impact in terms of reducing the probability and severity of future financial crises.[22] This would lead to a reduction in the cost of future financial crises by £4.7bn per annum, which, when compared to GDP costs of ICB implementation, still delivers a net benefit, of approximately of £3bn – £4bn per annum, to the UK economy.

93. Alternatively, the policy option still delivers a net benefit to the UK economy where it is assumed that the annual cost of financial crises to the UK is not £40bn as estimated by the ICB, but is instead

[19] "An assessment of the long-term economic impact of stronger capital and liquidity requirements": http://www.bis.org/publ/bcbs173.pdf.

[20] Permanent (scarring) effects is where, post-crisis, the level of GDP never reaches that determined by its trend growth rate pre-crisis. Post-crisis GDP grows at the same rate as pre-crisis, but the level of GDP is always below the levels determined by the pre-crisis growth rate.

[21] The 2010-2011 value of UK GDP has been used here for consistency when comparing with the ICB's calculations.

[22] So the current regulatory environment reduces the probability of financial crises by 15%; the policy option reduces the probability of financial crises by 12.5%; and the policy option reduces the cost to GDP of financial crises by 12.5%.

calculated by using the lowest estimated cost to GDP (17 per cent) and smallest probability of financial crises (3.5 per cent) from the Basel study. Using the numbers above, the benefit to GDP as a result of the policy option would be £2bn per annum, resulting in a net benefit of approximately £0.6bn – £1.4bn, to the UK economy.

94. Estimating the cost of future financial crises is highly uncertain, but academic studies and recent experience estimates them to be very large.[23] The Government believes that ICB implementation will reduce the cost of future financial crises to the UK economy and therefore deliver significant benefits to it.

Rationale and evidence that justify the level of analysis used in the IA

Proportionality

95. Forming the lead policy option concerns a great number of variables on ring-fence design and loss-absorbency requirements. Therefore the number of potential policy options is too great to complete individual full IAs, and so the Government has compared a 'Do not implement ICB' option with an 'Implement ICB' option. The 'Implement ICB' option is based upon extensive modelling of the various costs and benefits of policy variables, based on the recommendations of the ICB that could make up such an option.

96. Thorough and extensive analysis has been undertaken to determine the best way for the Government to implement the ICB recommendations, and of the costs and benefits of the lead policy option. The estimates presented in this IA are consistent with those presented by the ICB following the conclusion of their 15-month consultation period.

Wider impacts

97. There are a number of wider impacts that have been considered for both policy options. These are detailed below.

The distribution of the impact in the market

98. The aggregate private costs to the banking industry are £4bn - £7bn. 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 ICB implementation, which gives them scope to find an optimal business model.

99. 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

100. An increase in private costs to banks may be mitigated to some extent by reducing overall levels of remuneration. However, it is not clear whether, or the extent to which, banks would cut jobs or pay.

101. An argument could be made that there may be a greater employment impact in certain areas of the UK than others. So for example, if one assumes that the banks cut a relatively greater proportion of jobs in their investment section of their businesses than the retail side, this is likely to lead to a proportionately greater number of job losses in London (where the investment banking head offices are for most of the large UK banks) than in other areas of the country. On the other hand, if banks looked to reduce employment in the retail sector of their business, this is more likely to be dispersed across the country through their branch network.

[23] For example see Figure 5.1 of the ICB's final report.

102. As a guide, 30 per cent[24] of employment in Financial Services and Insurance activities[25] for the UK is in London, and so any job losses that may occur are more likely to be concentrated in the London area than elsewhere.

103. The extent to which banks absorb the private costs of the policy option and subsequently where such costs will be absorbed, is a commercial decision for each bank, and so cannot be modelled with any certainty.

Business borrowing distortions

104. 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 not be affected by the increase in bank lending costs. SMEs on the other hand may be dependent upon funding from banks and thus see their business costs increase.

105. It is hard to determine what the effect will be on businesses as there is uncertainty around both the response of banks to an increase in their private costs (the costs may not be passed on to SME businesses) and the response of businesses to any increase in their funding costs.

Impact on competition in the UK banking sector

106. Reducing the perceived implicit government guarantee for large UK banks that are 'too big to fail', should support competition in the UK banking sector. If big banks are seen as benefiting from a guarantee, this gives them an advantage over small ones in the form of lower wholesale funding costs.[26] Smaller banks do not benefit by such a guarantee, which means their funding costs are relatively higher. Reducing the perceived implicit guarantee would lead to large UK banks' cost of funding increasing, as the probability and loss given default values are now not reduced artificially. This will reduce the competitive disadvantage for smaller banks and should lead to greater competition in the market.

107. A de minimis exemption for small UK banks promotes competition in the banking sector. A de minimis exemption will prevent smaller banks from facing the relatively large costs of segregating their business and the ongoing costs associated with this. This will support smaller banks operating in the UK.

108. The impact on competition in the UK banking sector detailed here is specific to the lead policy option. The ICB's competition recommendations, as detailed in paragraph 10, are not considered in this IA.

Impact on competitiveness of UK banking sector

109. The Government believes that the policy option 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 taxpayer's expense less likely in the future.

110. ICB implementation will ensure that the UK banking sector will remain competitive, as:
    - the business activities of ring-fenced banks mean that they will compete predominantly with other ring-fenced banks in the UK. Individuals and SMEs in the UK predominantly use domestic banks for banking services, and so ring-fenced banks will not be at a competitive disadvantage; [27] and

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[24] ONS Data, "Workforce Jobs by Region and Industry", Average for 2011.

[25] Data for purely the banking sector would be more accurate but was unattainable at the time. However, it is very likely that jobs in the banking sector will have a relatively greater proportion based in London.

[26] The ICB final report presents figures from Moody's which suggest that larger banks benefit from a 2-5 notch upgrade in the rating of their debt when investors believe that there is an implicit government guarantee.

[27] ICB final report, paragraph 7.1.

- non-ring fenced banks, and all other global operations of UK-headquartered G-SIBs outside the ring-fence, which will compete in the UK and beyond, will face capital requirements in line with those currently being determined internationally.[28]

111. Also, the Government has considered further how to preserve the competitiveness of the UK banking sector in implementing the ICB. For example, it proposes that:
    - UK headquartered G-SIBs will not be required to hold additional PLAC in relation to those overseas operations that are not considered to be a risk to EEA financial stability; and
    - preferring a leverage ratio in line with international standards, rather than the 4.06 per cent level recommended by the ICB.

Expected finance and resource impact on other departments

112. Enforcing and policing ICB implementation will incur costs to the PRA. The FSA has estimated the upfront cost of implementing the proposals to the regulator to be no more **£20m**, with subsequent enforcing/policing costs of **£2m** per annum.

Equality impact

113. The Government considers that these proposals do not have a specific impact on racial equality.

114. The Government considers that these proposals do not have an impact on disability equality.

115. The Government considers that these proposals do not have an impact on gender equality.

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

Summary and implementation plan

Chosen policy option

117. The Government therefore proposes to proceed with the lead policy option (option 2), pending the outcome of the white paper consultation. As discussed before, the Government believes that implementing the ICB recommendations will deliver the greatest net-benefit having considered the various options for reform.

Implementation plan

118. Following the white paper consultation, a final implementation IA will be published when legislation is brought forward in this parliamentary session, confirming the Government's chosen policy option.

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[28] Entities of UK-headquartered G-SIBs incorporated in other countries will of course be subject to local regulatory requirements.

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ISBN 978-0-10-183562-6

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