EXPLANATORY MEMORANDUM TO

THE FINANCIAL SERVICES AND MARKETS ACT 2000 (CONTRIBUTION TO COSTS OF SPECIAL RESOLUTION REGIME) REGULATIONS 2010

2010 No. [XXXX]

1. This explanatory memorandum has been prepared by HM Treasury and is laid before Parliament by Command of Her Majesty.

This memorandum contains information for the Joint Committee on Statutory Instruments.

2. Purpose of the instrument

2.1 The purpose of the instrument is to allow the Treasury to call upon Financial Services Compensation Scheme (FSCS) to contribute to costs associated with the exercise of a stabilisation power of the special resolution regime (SRR) under Part 1 of the 2009 Act to resolve a failing bank or building society.

2.2 The instrument also provides for any safeguards for the use of these powers, namely: a cap on the amount that FSCS can contribute to; independent verification of resolution costs that the FSCS will contribute to; and independent valuation of what the FSCS would have received in terms of recoveries had a stabilisation power not been used.

3. Matters of special interest to the Joint Committee on Statutory Instruments

7.1 The Banking Act 2009 amended the Financial Services and Markets Act 2000 (FSMA) to allow the Treasury to require the FSCS to contribute to the cost of resolving a bank or building society using the SRR. The amount that FSCS can be required to contribute was capped at the amount that FSCS would have had to pay out if the authorities had not intervened and the failed firm had gone into insolvency.

7.2 The detailed provisions were set out in The Financial Services and Markets Act 2000 (Contribution to Costs of Special Resolution Regime) Regulations 2009 (no. 807). Those Regulations were made on an urgent basis on 29 March 2009 to enable the resolution of the Dunfermline Building Society ('Dunfermline'). They came into force on the day that they were made, and were laid before Parliament on 30 March 2009.

7.3 The Treasury carried out an *ex post* consultation from 21 July – 31 October 2009, with a view to making amending Regulations if necessary in light of consultation responses.

7.4 The Financial Services Act 2010 made changes to the provisions that were inserted into FSMA by the Banking Act. The main change was to allow the cap on the FSCS contributions to reflect the interest costs the FSCS would have incurred in paying compensation; and interest to be included in the resolution "expenses" to

which to which the FSCS can be asked to contribute. These amendments brought the provisions in line with normal commercial and government practice.

7.5 The Financial Services Act 2010 section 16(2) provides that where a stabilisation power has been exercised before the coming in force of section 16, the inclusion of interest takes effect from 19 November 2009 (the date of the introduction of the Bill). This includes interest costs that arise after this date for the resolution of Dunfermline. Therefore, in the accounts established in accordance with Schedule 1 of the Regulations in respect of the resolution of Dunfermline, interest is to be applied to these accounts as from 19th November 2009.

7.6 In light of amendments to the relevant provisions of FSMA made by the Financial Services Act 2010, the Treasury carried out a second public consultation on new Regulations from 15 March – 15 June 2010. The revised Regulations deal with points raised by respondents in response to both consultations.

4. Legislative Context

4.1 These Regulations are made by the Treasury, in exercise of the powers conferred by sections 214B, 214D and 428(3) of the Financial Services and Markets Act 2000 (FSMA), which were inserted into FSMA by section 16 of the Financial Services Act 2010.

4.2 These Regulations repeal and replace the Financial Services and Markets Act 2000 (Contribution to Costs of Special Resolution Regime) Regulations 2009 ('the 2009 Regulations'). The 2009 Regulations were made under section 214B of FSMA, inserted by section 171 of the Banking Act 2009.

5. Territorial Extent and Application

5.1 This instrument applies to all of the United Kingdom.

6. [European Convention on Human Rights

The Financial Secretary to the Treasury has made the following statement regarding Human Rights:

"In my view the provisions of the Financial Services And Markets Act 2000 (Contribution to Costs of Special Resolution Regime) Regulations 2010 are compatible with the Convention rights"]

7. Policy background

- ***What is being done and why***

7.7 These Regulations put in place detailed arrangements for requiring the FSCS to contribute to SRR costs and repeal the 2009 Regulations.

7.8 The new Regulations do the following things:

7.8.1 they enable the Treasury to notify the FSCS that the FSCS is required to make payments in respect of the resolution, and set out the type of information that is to be contained in such a notification. This will include information as to the institution itself, information as to recoveries the Treasury expects to make in respect of the expenses it, or another party, has incurred as part of the resolution process. It will also set out the interest rate to be applied to the accounts kept by the Treasury (see below);

7.8.2 they require the FSCS to determine the amount of compensation it would have paid out in respect of that institution had it been left to go into normal insolvency and the FSCS triggered to pay compensation to eligible depositors;

7.8.3 they require a valuer to determine the amount that the FSCS, having paid out compensation to depositors, would have been able to recover from the insolvent institution;

7.8.4 they allow the Treasury to specify to the FSCS and the valuer principles or specific methods to be used when making their respective determinations;

7.8.5 they allow the FSCS to make payments before the end of the resolution (either voluntarily or if required to do so by the Treasury);

7.8.6 they require the Treasury to set up accounts to work out

7.8.6.1 the net cost of resolution (by setting up and expenses account and a recoveries account);

7.8.6.2 the FSCS's limit;

7.8.6.3 the total cost of any interim payments; and

7.8.6.4 any balancing payments to be made to or required from the FSCS where it has previously made interim payments;

7.8.7 these accounts to incur interest at a notified rate. (In the accounts to establish the FCSC's limit, interest is added to reflect what the FSCS would have had to borrow to make compensation payments);

7.8.8 they also require the above accounts to be audited;

7.8.9 they require for the valuer's determination, the FSCS's determination and any calculation the Treasury under the Regulations to be referred to the Upper Tribunal for consideration;

7.8.10 they make transitional provision for previous notifications made under the 2009 Regulations.

- ***Consolidation***

7.9 None – these Regulations revoke and replace the 2009 Regulations.

8. Consultation outcome

8.1 Respondents raised broadly similar points in response to both consultations (21 July – 31 October 2009 and 15 March – 15 June 2010). Some respondents took the view that the Regulations will impose additional costs on banks, and it was suggested that there should be a further impact assessment. Respondents emphasised the importance of cost control and accountability mechanisms, suggesting various mechanisms by which this should be achieved:

8.1.1 industry should be permitted oversight of the balance sheet of the firm in the SRR;

8.1.2 the authorities should have regard to securing best value for money in carrying out resolutions;

8.1.3 the independent verification process should cover the cost-effectiveness of spending in a resolution;

8.1.4 the information and assumptions on which the FSCS's calculation is based should be set out in more detail, so that it can be challenged or questioned by an appropriate oversight body;

8.1.5 the National Audit Office (NAO) should have the power to investigate SRR expenditure; and

8.1.6 approximate costs should be communicated to the levy payers as soon as possible for accounting purposes.

8.2 There was no consensus among respondents on the question of whether the High Court or Court of Session should be replaced with the Financial Services and Markets Tribunal (now the Upper Tribunal) as the forum for review of the independent valuer's decisions, and respondents requested more information about the rationale for the change.

8.3 The Government shares concerns about minimising the costs of resolution. These Regulations are concerned only with calculating the proportion of the expenses incurred under an SRR measure that can be met by the FSCS. The existing SRR objectives cover the key elements of a successful SRR action: protecting financial stability, protecting depositors and protecting property rights. These objectives take into account the costs to the financial services industry of action taken under the SRR. However, there is no power in sections 214B- 214D to enable to enable the Treasury make Regulations that would give the authorities an explicit 'least cost to industry' objective in the SRR, or give levy payers oversight of the balance sheet of a firm subject to the SRR.

8.4 Regarding audit, the NAO examines the Treasury's expenses as part of its remit to review Treasury expenditure. Expenses incurred by the Treasury under the SRR would be reviewed by the NAO as such. With respect to expenditure under the SRR by other authorities such as the Bank of England, the Court of the Bank of

England is under a duty to ensure that the Bank makes efficient use of its resources, but it is not audited by the NAO. There is no power in sections 214B- 214D to enable the Treasury to require through the Regulations that costs incurred by the Bank of England are an efficient use of resources or similar.

8.5 The FSCS communicates regularly with industry about levies through newsletters available on its website. The Government does not believe that it would be appropriate to use these Regulations to require estimated resolution costs to be communicated to the levy payers as soon as possible. The FSCS will have access to information necessary to make this assessment as it becomes available (for example, about expected recoveries from the bank administration procedure). It is for the FSCS to calculate the levies that will be required, and communicate this to levy payers as they do with other costs.

8.6 The Regulations specify that the Upper Tribunal should be used, rather than the High Court or Court of Session (as was the case under the 2009 Regulations). The Tribunal will hear references made by the Treasury or the FSCS in relation to disputes about: the valuer's determination; the FSCS's determination of the compensation that would have been payable; and calculations made by the Treasury under the Regulations. The Upper Tribunal has recently subsumed the jurisdiction of the Financial Services and Markets Tribunal. Using the Upper Tribunal will mean that judges with relevant expertise can be appointed to hear the reference.

8.7 The FSCS contribution to SRR costs provisions do not impose additional costs on banks, because the cost to FSCS levy payers is capped at the amount that they would have had to pay out if the failed firm had gone into insolvency. This is set out in more detail in the impact assessment (IA) that was published with the Banking Act 2009 and the Financial Services Act 2010. Both are available from www.hm-treasury.gov.uk. The Government does not believe that a further impact assessment is necessary.

9. Guidance

9.1 Not applicable

10. Impact

10.1 An impact assessment (IA) was published with the Banking Act 2009 and the Financial Services Act 2010 and is available from www.hm-treasury.gov.uk.

11. Regulating small business

11.1 These Regulations will impact on FSCS levy payers, some of which are small businesses. However levy payers will not be required to pay more than they would have had to pay if the authorities had not intervened and the failed firm had instead gone into insolvency.

12. Monitoring & review

12.1 The impact of these Regulations will be monitored and reviewed by the Treasury.

13. Contact

Chris Rusbridge at HM Treasury Tel: 020 7270 4552 or email: christopher.rusbridge@hmtreasury.gsi.gov.uk can answer any queries regarding the instrument.