EXPLANATORY MEMORANDUM TO

THE FINANCIAL SERVICES AND MARKETS ACT 2000 (RING-FENCED BODIES AND CORE ACTIVITIES) ORDER 2014

2014 No.

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 To define the circumstances when accepting a deposit is not a core activity under section 142B of the Financial Services and Markets Act 2000 ("FSMA"), as amended by the Financial Services (Banking Reform) Act 2013, so that the deposits in question may be held by banks which are not ring-fenced bodies, and to exempt certain banks from the definition of "ring-fenced body" under section 142A of FSMA.

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

3.1 None.

4. Legislative Context

4.1 Section 4 of the Financial Services (Banking Reform) Act 2013 inserts a new Part 9B into FSMA providing for ring-fencing. Section 142A defines a ring-fenced body as a UK institution which carries on one or more core activities. Section 142B provides for a single core activity – the regulated activity of accepting deposits. The Treasury has power both to exempt classes of UK institutions from the definition of ring-fenced body, and to provide for exemptions to the core activity.

5. Territorial Extent and Application

5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

The Economic 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 (Ring-fenced Bodies and Core Activities) Order 2014 are compatible with the Convention rights.

7. Policy background

- What is being done and why

7.1 The financial crisis of 2007-09 revealed the urgent need for structural reform of the UK banking system to tackle the problem posed by banks seen as 'too big to fail'. Banks that cannot be allowed to fail without causing very serious harm to the wider economy benefit from perceived implicit government support.

7.2 A central element of the Government's programme of structural reform of the UK banking system is the ring-fencing of retail from wholesale/investment banking. Ring-fencing was a key recommendation of the Independent Commission on Banking (ICB), chaired by Sir John Vickers, established in 2010 to make recommendations on the reforms necessary to avoid future financial crises. The Government accepted the ICB's recommendations in December 2011.

7.3 The framework for ring-fencing was set out in the Financial Services (Banking Reform) Act 2013 (the "Banking Reform Act"), which provides for the separation of core activities (deposit taking) which must be carried out by ring-fenced bodies from excluded activities (trading in investments) which ring-fenced bodies are not permitted to do. The Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014 defines what activities ring-fenced bodies may not do. This Order defines which banks are ring-fenced bodies, and the activities which can only be done by ring-fenced bodies.

7.4 It exempts two classes of institutions from 'ring-fenced body'. The first class of institutions exempted are non-bank institutions such as insurers, co-operatives and community benefit societies, which are captured by the definition of 'ring-fenced body' in the Banking Reform Act because they accept deposits. Ring-fencing is a policy developed to deal with the specific characteristics of banks and banking services. It was not designed as a solution to the regulatory challenges of other financial services firms, therefore, it is appropriate that non-bank deposit-takers are exempted.

7.5 The second class of institutions exempted are banking groups which hold less than £25 billion in 'core deposits'. This exemption ensures that small banks will not be subject to ring-fencing requirements, which would impose disproportionate costs in the case of small banks, impeding their ability to compete and grow. The costs of ring-fencing could also deter new banks from entering the markets. The Order also creates a fixed 4 year 'grace period' from ring-fencing for banks which expand due to a merger or acquisition and cross the £25 billion threshold suddenly, in order to give firms planning such transactions a degree of certainty over the requirements to which they will be subject.

7.6 This Order also provides that accepting a deposit is not a 'core activity' if the deposit is not a 'core deposit', and sets out the circumstances in which a deposit is a 'core

deposit'. The effect is that core deposits have to be held by a bank which is a ring-fenced body.

7.7 A deposit is only a core deposit if it is held with a bank in an account opened at a branch in the EEA. The purpose of ring-fencing is to protect those banking services where continuous provision is essential to the UK economy. This does not apply for non-EEA deposits, therefore it is appropriate that non-EEA deposits do not have to be held inside the ring-fence.

7.8 The Order provides that the deposits of organisations with a turnover greater than £6.5 million, more than 50 employees or a balance sheet total greater than £3.26 million, and individuals with more than £250,000 worth of financial assets (high-net worth individuals) will not be core deposits. Such depositors will be able to choose to bank outside the ring-fence. This implements the ICB recommendation that high net worth individuals and large organisations should be able to bank outside the ring-fence, if they make an active choice to do so. The Order sets out the process depositors must go through to certify that their deposits are not core deposits. It also requires the regulators to make rules on the information which non-ring-fenced bodies[1] must provide to individuals who bank (or wish to bank) with them in order to enable such individuals to make an informed choice about where they should bank.

7.9 The Order excludes deposits of 'relevant financial institutions' (defined in the Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions Order) 2014) from the definition of "core deposit", so that those financial institutions may, regardless of their size, deposit with non-ring-fenced bodies. .

- Consolidation

7.10 This Order does not amend any existing secondary legislation, and no consolidation is necessary.

8. Consultation outcome

8.1 The Government published this Order in draft for consultation in July 2013: *Banking Reform: draft secondary legislation*. A summary of responses to the consultation was published in December 2013: *Banking reform draft secondary legislation: summary of responses*. In the light of consultation responses, the Government made a number of technical changes to the legislation to ensure that it achieved the financial stability objectives of ring-fencing while minimising any negative impact on the wider economy.

8.2 The consultation document and summary of responses can be found online: https://www.gov.uk/government/consultations/banking-reform-draft-secondary-legislation

[1] 'Non-ring-fenced bodies' is defined in the Order as deposit-takers which are not ring-fenced bodies, or bodies which have been exempted from ring-fencing – i.e. any deposit-taker which is not a ring-fence body but is part of a corporate group that contains a ring-fenced body. .

9. Guidance

9.1 There are no current plans to publish any guidance.

10. Impact

10.1 The impact on business, charities or voluntary bodies is expected to arise from the pass-through by banks of increased costs to their customers. The cost to banks arises primarily from the withdrawal of the implicit subsidy represented by the perceived implicit government guarantee to banks seen as 'too big to fail'. If investors presume that a bank benefits from implicit government support (i.e. that the government would use public funds to rescue the bank if it ran into financial difficulties), they will demand a lower price to lend to that bank, reflecting the lower risks the investors face. Conversely, as the perceived implicit government guarantee is withdrawn, the price demanded by investors, and hence banks' costs of funding, will rise. In addition, banks may face some administrative costs from the separation of retail from investment banking.

10.2 How banks respond to these increased private costs will depend on each bank's commercial judgement. Banks have multiple options, including passing costs on to shareholders (in lower profits), employees (in lower remuneration) or customers (in some combination of lower savings rates and/or higher borrowing rates).

10.3 The social cost (i.e. cost to GDP) of ring-fencing arises indirectly, from behavioural changes produced by changes in returns to bank investors and employees and/or by changes in savings and borrowing rates. The social cost is not the same as the private cost to UK banks. As a significant proportion of the private cost represents the withdrawal of the implicit subsidy (which is a transfer of cost within the economy, not a cost to GDP), the estimated social cost is lower than the private cost.

10.4 The social cost of ring-fencing will, however, be outweighed by the benefits of increased financial stability. As financial crises impose very large costs on the economy, the benefits of avoiding crises (or reducing their severity) in the future are commensurately large, albeit difficult to quantify. On the basis of academic estimates of the costs of financial instability, if (on conservative estimates) regulatory reforms reduced the likelihood and severity of future financial crises by 40% each, and if ring-fencing were responsible for 25% of the effect of regulatory reform, the economic benefits of ring-fencing would be equivalent to 0.54% of UK GDP per annum (equivalent to a benefit of £8.8 billion per annum in 2013 terms).

10.5 The impact on the public sector arises through a number of channels. The direct cost to the regulator of enforcing the ring-fence is estimated at up to £2 million per annum (with £20 million start-up costs). As the primary driver of tax receipts in the long run is the level of GDP, the gross reduction in GDP from ring-fencing would depress tax receipts. But this effect would be offset by the GDP benefit of improved financial stability, including the reduced long-run costs to the public finances of periodic financial

crises. Finally, as the perceived implicit government guarantee to banks seen as 'too big to fail' represents a contingent liability on the public finances, the withdrawal of the perceived implicit government guarantee should feed through to lower UK sovereign borrowing costs, all else being equal.

10.6 The Impact Assessment provided for the Act and draft secondary legislation can be found in Annex E of *Banking Reform: draft secondary legislation* at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/223566/PU1488_Banking_reform_consultation_-_online-1.pdf.

11. Regulating small business

11.1 The legislation does not apply to small business.

12. Monitoring & review

12.1 Section 8 of the Banking Reform Act requires HM Treasury to establish an independent review of the operation of ring-fencing legislation, including this order within two years of the date on which the legislation comes into force.

13. Contact

Sebastian Astin-Chamberlain at the Treasury Tel: 020 7270 1051 or email: Sebastian.astin-chamberlain@hmtreasury.gsi.gov.uk can answer any queries regarding the instrument.