EXPLANATORY MEMORANDUM TO

THE FINANCIAL SERVICES AND MARKETS ACT 2000 (BANKING REFORM) (PENSIONS) REGULATIONS 2015

2015 No. 547

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 ensure that ring-fenced banks are not, and cannot become, liable for the pension liabilities of other bodies (except ring-fenced banks in the same group or wholly owned subsidiaries of ring-fenced banks in the same group).

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 the Financial Services and Markets Act 2000 ("FSMA") providing for ring-fencing. Section 142W, in conjunction with section 428(3) and section 429(2), grants the Treasury powers to make regulations requiring the ring-fenced bank to make arrangements for the purpose of meeting certain pensions criteria (as may be prescribed under section 142W(1)(a)-(c)).

4.2 Under section 142W, amongst other things, the Treasury may make regulations that enable pension scheme trustees and managers to transfer existing pension liabilities or divide existing pension schemes, and may make regulations that provide for a court to decide on certain disputes regarding proposed arrangements. Section 142W also states that any regulations made under it may require a clearance statement from the Pensions Regulator.

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 (Banking Reform) (Pensions) Regulations 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'. 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 should insulate retail banking services (whose continuous provision is essential to financial stability and to the wider economy) from shocks originating elsewhere in the global financial system, make ring-fenced retail banks simpler and easier for the authorities to resolve and reduce the perceived implicit government guarantee to systemic banks.

7.2 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 and legislated to implement the ring-fence via the Financial Services (Banking Reform) Act 2013. Two pieces of secondary legislation, which set out what activities can be carried out inside the ring-fence and what activities are excluded from the ring-fence, were approved by Parliament on 23 July 2014. The Prudential Regulation Authority (PRA) is in the process of developing rules on ring-fencing, including rules on the legal structure and governance of a ring-fenced body.

7.3 A key principle of ring-fencing is that the ring-fenced bank must be economically independent of other entities in its banking group, to the extent that the failure of another group member cannot threaten the viability of an otherwise healthy ring-fenced bank. In order to ensure this economic independence, the Government must require ring-fenced banks to ensure that they are not, and cannot become, liable for the future pension liabilities relating to other members of its group, or outside companies. Government intervention is necessary as the PRA's existing rule-making powers would not enable the PRA to make rules covering all aspects of separation of pension liabilities (e.g., the PRA does not have the power to make rules for pension scheme trustees or managers). In order to implement this aspect of ring-fencing, the Treasury will need to exercise the power it has to make regulations to this effect.

7.4 These Regulations ensure that ring-fenced banks will be economically independent of the rest of their corporate group, and shall not be liable for funding any deficit in any group-wide pension schemes. The Regulations achieve this by requiring ring-fenced banks to make arrangements to ensure that they cannot be liable for the future pensions liabilities of other group members (except other group ring-fenced banks, or wholly owned subsidiaries of group ring-fenced banks) or of outside companies.

7.5 The Regulations also allow the pension schemes' trustees to make the necessary changes to implement the ring-fencing, set out that ring-fenced banks must apply to the

Pensions Regulator (TPR) for a clearance statement for any restructuring that is likely to be materially detrimental and set out the relevant roles of TPR and the PRA.

- Consolidation

7.6 These Regulations do not amend any existing secondary legislation, and no consolidation is necessary.

8. Consultation outcome

8.1 The Government published these regulations in draft for consultation in July 2014: *Banking reform: draft pensions regulations*. The consultation document can be found online at: https://www.gov.uk/government/consultations/banking-reform-draft-pensions-regulations.

8.2 In the light of consultation responses, the Government made a number of technical changes to the legislation to ensure that these regulations are clear and achieve their purpose. The Government also made two substantial changes to these regulations following the consultation in order to limit the burden on the banks and regulators, by adding in a materiality threshold for clearance and by removing unnecessary reporting requirements. A summary of responses to the consultation will be published in early 2015

9. Guidance

9.1 There are no current plans to publish guidance. However an industry working group has been established, chaired by HMT, which brings together banks, trustees and regulators. To date this has acted as a forum for discussing the draft regulations in parallel to the consultation; going forward this will focus more on implementation.

10. Impact

10.1 These regulations will have an impact on banks' costs. There will be an administrative cost to banks of implementing the required changes to their pension schemes. This cost is expected to be no larger than £50m across all the affected banks. There are also further transitional costs to the banks as a result of handling potential Section 75 payments (essentially upfront payments from employers departing a scheme) and as a result of changes to the bank's employer covenant. The Regulations give banks a great deal of flexibility in carrying out any restructuring necessary to comply and the details of how each scheme will eventually be restructured cannot be predicted by the Government and so these costs cannot be monetised. However rough calculations suggest that the cost to the bank of any Section 75 payments will be minimal and that the cost to the banks of the changes to employee covenant will likely be in the order of magnitude of tens of millions of pounds.

10.2 Banks will probably look to pass-through costs to their shareholders, employers and/or customers. There is therefore expected to be some impact on businesses, charities or voluntary bodies which will arise from behavioural changes produced by changes in returns to bank investors and employees and/or by changes in savings and borrowing

rates. Exactly how banks pass on these costs will depend on each bank's commercial judgement.

10.3 There will also be a small cost to the regulators of enforcement and of ensuring that this legislation is successfully implemented by the banks. The cost to the PRA is estimated at £1 million per annum. The cost to TPR is estimated at £1.3 million spread over the next 10 years.

10.4 The cost of ring-fencing will 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 it has been estimated by HMT that the annual economic benefit of greater financial stability as a result of ring-fencing to be 0.54% of GDP (equivalent to £8.8 billion in 2013 terms) and the net benefit of ring-fencing as a whole to be £145 billion. Requiring ring-fenced banks to ensure as far as possible that they are not, and cannot become, liable for the pension liabilities of other group members, or outside bodies forms part of this very large overall benefit. These benefits are significant compared to the costs that are likely to be in the low hundreds of millions of pounds.

10.5 An Impact Assessment is attached to this memorandum and will be published alongside the Explanatory Memorandum on the legislation.gov.uk website.

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 the Treasury to establish an independent review of the operation of the ring-fencing legislation by 2021 (within two years of the rest of the ring-fencing rules coming into force). This measure will be reviewed alongside the rest of the ring-fencing. It is impossible to say how many of the banks will have restructured their pension schemes at this time. It will be decided in 2021 whether this measure requires a further review at a later date.

13. Contact

Samuel Hilton at the Treasury Tel: 020 7270 4341 or email: samuel.hilton@hmtreasury.gsi.gov.uk can answer any queries regarding the instrument.