EXPLANATORY MEMORANDUM TO

THE FINANCIAL SERVICES AND MARKETS ACT 2000 (EXCLUDED ACTIVITIES AND PROHIBITIONS) ORDER 2014

2014 No. 2080

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 activities that may not be carried on by ring-fenced bodies.

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. Those UK institutions which carry on one or more core activities (defined in new section 142B of FSMA as the regulated activity of accepting deposits, subject to any exceptions provided for by the Treasury by Order) will be ring-fenced bodies. As such they will not be permitted to carry on excluded activities, defined in new section 142D of FSMA, or to do anything prohibited by the Treasury under section 142E. Section 142D defines a single excluded activity: the regulated activity of dealing in investments as principal, except in circumstances specified by the Treasury. This Order provides for a number of cases in which ring-fenced bodies are to be permitted to deal in investments in principal, and imposes a number of prohibitions (subject to exceptions) on what ring-fenced bodies may do.

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 (Excluded Activities and Prohibitions) 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 (Ring-fenced Bodies and Core Activities) Order 2014 defines precisely which banks are ring-fenced bodies, and the activities which may only be done by ring-fenced bodies. This Order defines what activities ring-fenced bodies may not do.

7.4 The Banking Reform Act provides that the regulated activity of dealing in investments as principal is an "excluded activity", and may not be carried out by ring-fenced bodies except in circumstances specified by the Treasury. It also gives the Treasury power to create additional excluded activities, and to impose prohibitions on ring-fenced bodies. This Order provides that dealing in commodities (e.g. precious metals, oil, agricultural products) is an excluded activity: this will insulate ring-fenced bodies against swings in global commodity prices.

7.5 This Order also creates exceptions to excluded activities. First, it permits ring-fenced bodies to deal in investments as principal for the purpose of reducing its exposure to specified risks, including interest rate, currency and liquidity risk. This exception, following a recommendation of the ICB, will allow ring-fenced bodies prudently to manage the risks arising from its central business of intermediating between savers and borrowers. Second, the Order permits ring-fenced bodies to trade with central banks. This means ring-fenced bodies will not be prevented from accessing central bank liquidity. Third, the Order creates an exception to permit ring-fenced bodies to sell a narrow range of simple derivatives to their customers, such as interest rate swaps and simple foreign exchange options. This allows ring-fenced bodies to provide the basic risk-management services used by many business customers, including small businesses. Ring-fenced bodies' derivatives portfolios will be subject to a series of safeguards, including caps on portfolio size and riskiness, and requirements that all derivatives sold by ring-fenced bodies be traded in liquid markets and valuable on the basis of observable market inputs.

7.6 To protect ring-fenced bodies against intra-financial contagion, the Order prohibits ring-fenced bodies from having exposures to other financial institutions outside their own corporate group, including non-ring-fenced banks, investment firms, systemic insurance firms and investment funds. This prohibition is subject to exceptions. First, ring-fenced bodies may have exposures for the purpose of managing their own risks, analogous to the exception from the excluded activity of dealing in investments as principal. Second, ring-fenced bodies may have exposures to other financial institutions for the purpose of providing trade finance services. This will allow ring-fenced bodies, for example, to confirm letters of credit issued by foreign banks for the benefit of UK exporters. Third, ring-fenced bodies may have exposures arising from the provision of payments services to other financial institutions, subject to any requirements imposed by the regulator. This is to permit ring-fenced bodies to act as clearing banks for other financial institutions, while mitigating the risks involved through robust supervision. In addition to the prohibition on financial institution exposures, the Order prohibits ring-fenced bodies from establishing branches or subsidiaries (except for service companies) outside the European Economic Area. This will reduce ring-fenced bodies' interconnectedness with the global financial system, insulating them against global financial shocks and making them more resolvable in the event of failure.

- Consolidation

7.8 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.

9. Guidance

9.1 There are no current plans to publish 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).

10.2 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.

10.3 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 the Treasury to establish an independent review of the operation of the ring-fencing legislation, including this Order within two years of the date on which this legislation comes into force.

13. Contact

Ian Ginsberg at the Treasury Tel: 020 7270 5967 or email: ian.ginsberg@hmtreasury.gsi.gov.uk can answer any queries regarding the instrument.