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| Title: Impact assessment of UK implementation regulations of the EU directive on settlement finality and financial collateral arrangements. Lead department or agency: HM Treasury Other departments or agencies: | Impact Assessment (IA) |
| | IA No: |
| | Date: 10/12/2010 |
| | Stage: Development/Options |
| | Source of intervention: EU |
| | Type of measure: Secondary legislation |
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Summary: Intervention and Options

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

In April 2008 the Commission decided to amend the Settlement Finality Directive (SFD) and the Financial Collateral Arrangements Directive (FCD), bringing both Directives in line with market and regulatory developments in the post-trading area. The SFD aimed to reduce the systemic risk associated with participation in payment and securities settlement systems and FCD sought to expand on the role of collateral in SFD. These directives provide a key underpinning for the systemic robustness of the financial markets.

The Government now has to implement the directive to meet the European deadline of 30 December 2010, and is proposing to do this by amending existing domestic legislation.

What are the policy objectives and the intended effects?

The Commission produced a report in 2005 on the operation of the SFD and in 2006 on the operation of the FCD. Both reports concluded that the Directives had proved a success. However, some improvements were identified. The objectives of the amending Directive are to increase the efficiency and safety of the EU financial market and ensure a level playing field among the relevant participants, principally by facilitating the use of credit claims as collateral, ensuring the stability of settlement systems, and enhancing legal certainty. The proposed UK implementation regulations brings this into effect so UK industry stakeholders can benefit from these changes and work more effectively in a changing post trade environment.

What policy options have been considered? Please justify preferred option (further details in Evidence Base)

- 1) To amend the Financial Markets and Insolvency Regulations (1999) and the Financial Collateral Arrangements (No.2) Regulations 2003 in order to comply with the European Directive 2009/44/EC.
- 2) Not to implement.

Option 1 is preferred in view of the EU requirement to adopt and publish the laws, regulations and administrative provisions, necessary to comply with this Directive by 30 December 2010. The Directive will apply from 30 June 2011.

| | |
|--|--------------------------------|
| When will the policy be reviewed to establish its impact and the extent to which the policy objectives have been achieved? | It will be reviewed in 5 years |
| Are there arrangements in place that will allow a systematic collection of monitoring information for future policy review? | Yes |

Ministerial Sign-off For consultation stage Impact Assessments:

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: 13/12/10

Summary: Analysis and Evidence

Policy Option 1

Description:

Impact of amending Financial Markets and Insolvency Regulations (1999) and the Financial Collateral Arrangements (No.2) Regulations 2003

| Price Base Year | PV Base Year | Time Period Years | Net Benefit (Present Value (PV)) (£m) | | |
|-----------------|--------------|-------------------|---------------------------------------|-------------|----------------------|
| | | | Low: 0.5bn | High: £35bn | Best Estimate: £15bn |

| COSTS (£m) | Total Transition (Constant Price) Years | Average Annual (excl. Transition) (Constant Price) | Total Cost (Present Value) |
|---------------|---|--|----------------------------|
| Low | 0 | 0 | 0 |
| High | £10m | 0 | £1m |
| Best Estimate | 500k | 0 | 500k |

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

The principal monetised costs relate to system costs.

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

In the area of credit claims there could be indirect costs relating to any disadvantage suffered to creditors in the event of the insolvency of a company that has used credit claims as collateral.

| BENEFITS (£m) | Total Transition (Constant Price) Years | Average Annual (excl. Transition) (Constant Price) | Total Benefit (Present Value) |
|---------------|---|--|-------------------------------|
| Low | £0.5bn | TBC | £0.5bn |
| High | £35bn | TBC | £35bn |
| Best Estimate | £15bn | TBC | £15bn |

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

The European Commission has estimated the potential benefits for the euro area from bringing credit claims into the scope of the Financial Collateral Directive may amount to between Euro 3.5bn and Euro 263billion. The assumptions behind this estimate are outlined in the Commission's impact assessment on its proposals (link on p 3). A simple adjustment based on the relative size of UK and Eurozone GDP would suggest this figure might be E0.5bn to E35bn for the UK.

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

The implementation of the Amending Directive should offer benefits from reduced legal risk, reduced risk of systemic disruption to the key financial architecture of London's markets and potentially reduced funding costs in the form of collateral savings and additional liquidity available to financial institutions.

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

| | | |
|-----------------------------------|-------------------------------------|----------|
| Impact on admin burden (AB) (£m): | Impact on policy cost savings (£m): | In scope |
| New AB: | Policy cost savings: | Yes/No |
| AB savings: | Net: | |

Enforcement, Implementation and Wider Impacts

| | | | | | |
|---|----------------|------|-------------|--------|-------|
| What is the geographic coverage of the policy/option? | United Kingdom | | | | |
| From what date will the policy be implemented? | 30/06/2011 | | | | |
| Which organisation(s) will enforce the policy? | UK courts/FSA | | | | |
| What is the annual change in enforcement cost (£m)? | 0 | | | | |
| Does enforcement comply with Hampton principles? | Yes | | | | |
| Does implementation go beyond minimum EU requirements? | No | | | | |
| What is the CO ₂ equivalent change in greenhouse gas emissions? (Million tonnes CO ₂ equivalent) | Traded: | | Non-traded: | | |
| Does the proposal have an impact on competition? | No | | | | |
| What proportion (%) of Total PV costs/benefits is directly attributable to primary legislation, if applicable? | Costs: | | Benefits: | | |
| Annual cost (£m) per organisation (excl. Transition) (Constant Price) | Micro | < 20 | Small | Medium | Large |
| Are any of these organisations exempt? | No | No | No | No | No |

Specific Impact Tests: Checklist

Set out in the table below where information on any SITs undertaken as part of the analysis of the policy options can be found in the evidence base. For guidance on how to complete each test, double-click on the link for the guidance provided by the relevant department.

Please note this checklist is not intended to list each and every statutory consideration that departments should take into account when deciding which policy option to follow. It is the responsibility of departments to make sure that their duties are complied with.

| Does your policy option/proposal have an impact on...? | Impact | Page ref within IA |
|--|--------|--------------------|
| Statutory equality duties¹ Statutory Equality Duties Impact Test guidance | No | |
| Economic impacts | | |
| Competition Competition Assessment Impact Test guidance | No | |
| Small firms Small Firms Impact Test guidance | No | |
| Environmental impacts | | |
| Greenhouse gas assessment Greenhouse Gas Assessment Impact Test guidance | No | |
| Wider environmental issues Wider Environmental Issues Impact Test guidance | No | |
| Social impacts | | |
| Health and well-being Health and Well-being Impact Test guidance | No | |
| Human rights Human Rights Impact Test guidance | No | |
| Justice system Justice Impact Test guidance | No | |
| Rural proofing Rural Proofing Impact Test guidance | No | |
| Sustainable development Sustainable Development Impact Test guidance | No | |

¹ Race, disability and gender Impact assessments are statutory requirements for relevant policies. Equality statutory requirements will be expanded 2011, once the Equality Bill comes into force. Statutory equality duties part of the Equality Bill apply to GB only. The Toolkit provides advice on statutory equality duties for public authorities with a remit in Northern Ireland.

Evidence Base (for summary sheets) – Notes

Use this space to set out the relevant references, evidence, analysis and detailed narrative from which you have generated your policy options or proposal. Please fill in **References** section.

References

Include the links to relevant legislation and publications, such as public impact assessment of earlier stages (e.g. Consultation, Final, Enactment).

| No. | Legislation or publication |
|-----|--|
| 1 | EU impact assessment http://ec.europa.eu/internal_market/financial-markets/docs/proposal/impact_en.pdf |
| 2 | EU amending directive 2009/44/EC http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:146:0037:0043:EN:PDF |
| 3 | Settlement Finality Directive 98/26/EC http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:1998:166:0045:0050:EN:PDF |
| 4 | Financial Collateral Arrangements Directive 2002/47/EC http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2002:168:0043:0050:EN:PDF |
| 5 | The Financial Collateral Arrangements regulations 2003 Impact Assessment http://webarchive.nationalarchives.gov.uk/20100407010852/http://www.hm-treasury.gov.uk/d/idfca_ria_0104.pdf |

Evidence Base

Ensure that the information in this section provides clear evidence of the information provided in the summary pages of this form (recommended maximum of 30 pages). Complete the **Annual profile of monetised costs and benefits** (transition and recurring) below over the life of the preferred policy (use the spreadsheet attached if the period is longer than 10 years).

The spreadsheet also contains an emission changes table that you will need to fill in if your measure has an impact on greenhouse gas emissions.

Annual profile of monetised costs and benefits* - (£m) constant prices

| | Y ₀ | Y ₁ | Y ₂ | Y ₃ | Y ₄ | Y ₅ | Y ₆ | Y ₇ | Y ₈ | Y ₉ |
|----------------------------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
| Transition costs | | | | | | | | | | |
| Annual recurring cost | | | | | | | | | | |
| Total annual costs | | | | | | | | | | |
| Transition benefits | | | | | | | | | | |
| Annual recurring benefits | | | | | | | | | | |
| Total annual benefits | | | | | | | | | | |

* For non-monetised benefits please see summary pages and main evidence base section

Evidence Base (for summary sheets)

Background to the amending Directive (2009/44/EC)

On 6 May 2009 the European Parliament and Council adopted the Directive 2009/44/EC, which amends Directive 98/26/EC on settlement finality in payment and securities settlement systems, and Directive 2002/47/EC on financial collateral arrangements as regards linked systems and credit claims. Member states have until 30 December 2010 to adopt and publish the laws, regulations and administrative provisions, necessary to comply with this Directive, which will apply from 30 June 2011.

The Settlement Finality Directive (98/26/EC) was adopted in 1998, in order to reduce the systemic risk associated with participation in payment and securities settlement systems. Since 1998, the post-trading environment has changed considerably. When the original SFD was passed, systems operated on an almost exclusively national and independent basis. However since then systems have become increasingly linked /interoperable. In 2005, the Commission published an evaluation report and concluded that certain parts of the Directive needed to be revisited and amended.

The Financial Collateral Arrangements Directive (2002/47/EC) sought to expand on the role of collateral from the Settlement Finality Directive. The objective was to achieve greater integration and cost –efficiency of European financial markets, by simplifying the collateral process, improving legal certainty in the use of collateral and reducing risks for market participants. In December 2006, the European Commission published an evaluation report, which concluded that the directive was largely working well, but that some aspects would benefit from revision.

Due to the close links between the Settlement Directive and the Financial Collateral Arrangements Directive, the Commission concluded that both directives should be amended together under Directive 2009/44/EC.

These implementation regulations seek to amend the UK Financial Markets and Insolvency Regulations 1999, and the Financial Collateral Arrangements (No.2) Regulations 2003 in order to comply with the European Amending Directive 2009/44/EC.

Option 1 - To amend the Financial Markets and Insolvency Regulations (1999) and the Financial Collateral Arrangements (No.2) Regulations 2003 in order to comply with the European Directive 2009/44/EC.

Group of Measures 1: Introducing the concept of interoperable systems into law

Benefits: The Amending Directive changes various definitions and introduces various terms to ensure interoperable systems are brought into the regime with relevant protections clarified or extended where appropriate. At present, it is unclear whether interlinked systems fully benefit from the protections of the Settlement Finality Directive. By thus reducing the legal uncertainty surrounding the protections enjoyed by systems (e.g. clearing houses, settlement agents), which are linked to other systems, the risk of contagion in the financial system should be reduced. As such systems are vital for the proper functioning of financial markets, a contagion spreading through interlinked settlement systems could, in a worst-case scenario, cause widespread failures, leading to billions of pounds of costs.

As an illustration of the importance of maintaining the resilience of the systems designated under the SFD, we note that for example CHAPS handled an average daily value of £255 billion in 2009; representing almost 20% of annual UK GDP. Meanwhile the daily average value of cash moving through CREST was in the order of £908 billion in March 2010, including self-collateralising repo transactions.

Costs: These changes are clarifying ones and we have not identified any costs associated with them

Group of Measures 2: Providing clarity on calendar days and moments of entry

Benefits: The Directive clarifies that the SFD's protections apply to settlements that take place on the same business day as an insolvency is initiated, and obliges settlement systems to seek to co-ordinate their rules regarding the moment of entry and irrevocability of transfer orders. As with the measures outlined above, by reducing the legal uncertainty surrounding the protections enjoyed by systems (e.g.

clearing houses, settlement agents) which are linked to other systems, the risk of contagion in the financial system should be reduced. As such systems are vital for the proper functioning of financial markets, a contagion spreading through interlinked settlement systems could, in a worst case scenario, cause widespread, leading to billions of pounds of costs.

Costs: this could mean some implementation costs to industry, which we would not expect to be unduly burdensome. Systems which are interlinked will need to take steps to ensure that their rules governing the moment of entry and irrevocability of transfer orders are co-ordinated as far as possible. We are using the consultation process to seek more information from industry on the nature and scale of these costs, but have estimated them as between £0m and £10m in the meantime.

Group of Measures 3: Bringing credit claims into the scope of the FCD

Benefits: The Directive brings credit claims into the scope of the FCD's protections. The intention of this measure is to increase the pool of available collateral that banks can use. In principle, the availability of credit claims as a form of collateral could decrease the cost of funding for credit institutions, thus increasing lending with associated economic benefits. The Eurosystem has since 2007 accepted credit claims as collateral in its credit operations. Certain EU countries (such as Luxembourg) already include credit claims in the scope of their implementation of the FCD, meaning that implementation of the Amending Directive will put relevant UK entities on a level playing field with Entities in other EU jurisdictions. The European Commission has estimated (see reference 1 in list above) that the measure may benefit Euro area countries by E3.5bn to E263bn, in the form of collateral savings/additional liquidity available to financial institutions. (This estimate takes into account only the first-round effects and does not include any additional benefits that could come from financial institutions using this liquidity to fuel their businesses.) These potential benefits are of increased relevance to the UK in light of the Bank of England's announcement that it will accept credit claims as collateral for its Discount Window Facility. A simplistic adjustment based on the relative size of UK and Eurozone GDP would suggest this figure might be E0.5bn to E35bn for the UK. No comments were made on this estimate during the consultation stage.

Costs: There may be costs among industry relating to implementing systems for handling credit claims in case such systems are not already in place, although it should be borne in mind that there is no obligation for industry to use credit claims as collateral. In addition it can be observed that in the extended regime, if a credit institution were to go bankrupt, any credit claims pledged as collateral would not be available to repay the institution's creditors, disadvantaging those creditors versus a situation in which they had a claim on the collateral.

Option 2 – Not to implement

Benefits: Existing legislation would stay the same for the industry. The costs described above would not accrue.

Costs: The risks described above would not be addressed. In addition the UK runs the risk of infraction proceedings being initiated by the European Commission if we do not meet the implementation date of 31 December 2010.

Annexes

Annex 1 should be used to set out the Post Implementation Review Plan as detailed below. Further annexes may be added where the Specific Impact Tests yield information relevant to an overall understanding of policy options.

Annex 1: Post Implementation Review (PIR) Plan

A PIR should be undertaken, usually three to five years after implementation of the policy, but exceptionally a longer period may be more appropriate. A PIR should examine the extent to which the implemented regulations have achieved their objectives, assess their costs and benefits and identify whether they are having any unintended consequences. Please set out the PIR Plan as detailed below. If there is no plan to do a PIR please provide reasons below.

Basis of the review: [The basis of the review could be statutory (forming part of the legislation), it could be to review existing policy or there could be a political commitment to review];

Within 5 years of the implementation of the statutory instrument the Treasury will review the implementing regulations.

Review objective: [Is it intended as a proportionate check that regulation is operating as expected to tackle the problem of concern?; or as a wider exploration of the policy approach taken?; or as a link from policy objective to outcome?]

To ensure that the regulations remain an appropriate method of implementing the Amending Directive.

Review approach and rationale: [e.g. describe here the review approach (in-depth evaluation, scope review of monitoring data, scan of stakeholder views, etc.) and the rationale that made choosing such an approach]

Treasury officials will seek views of relevant stakeholders, such as system operators, the Bank of England and the FSA.

Baseline: [The current (baseline) position against which the change introduced by the legislation can be measured]

Success criteria: [Criteria showing achievement of the policy objectives as set out in the final impact assessment; criteria for modifying or replacing the policy if it does not achieve its objectives]

The Treasury and stakeholders consider that the implementing regulations continue to satisfactorily implement the provisions of the amending directive.

Monitoring information arrangements: [Provide further details of the planned/existing arrangements in place that will allow a systematic collection of monitoring information for future policy review]

Treasury officials are in regular contact with affected stakeholders.

Reasons for not planning a PIR: [If there is no plan to do a PIR please provide reasons here]

