

**EXPLANATORY MEMORANDUM TO**  
**THE FINANCIAL SERVICES AND MARKETS ACT 2000 (RING-FENCED BODIES,**  
**CORE ACTIVITIES, EXCLUDED ACTIVITIES AND PROHIBITIONS)**  
**(AMENDMENT) ORDER 2016**

2016 No. [XXXX]

**1. Introduction**

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

**2. Purpose of the instrument**

2.1 To make a number of technical amendments to the UK’s bank ring-fencing regime, which is due to come into force on 1 January 2019. These changes are being made to help facilitate an effective and timely implementation of the regime.

**3. Matters of special interest to Parliament**

*Matters of special interest to the Joint Committee on Statutory Instruments*

3.1 None

*Other matters of interest to the House of Commons*

3.2 Disregarding minor or consequential changes, the territorial application of this instrument includes Scotland and Northern Ireland.

**4. Legislative Context**

4.1 Section 4 of the Financial Services (Banking Reform) Act 2013 (“the 2013 Act”) inserts a new Part 9B into the Financial Services and Markets Act 2000 (“FSMA”) providing for ring-fencing. Further details of the ring-fencing regime are provided in secondary legislation.

4.2 Section 142A of the 2013 Act defines a ring-fenced body (“RFB”) 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 to exempt classes of UK institutions from the definition of ring-fenced body, and also to provide for exemptions to the core activity. The Treasury relied on this power to make the Financial Services and Markets Act 2000 (Ring-Fenced Bodies and Core Activities) Order 2014 (“CAO”).

4.3 RFBs will not be permitted to carry on excluded activities (defined in 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. The Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014 (“EAPO”) provides for a number of cases in which RFBs are to be permitted to deal in investments as principal, and imposes a number of prohibitions (subject to exceptions) on what RFBs may do.

- 4.4 The Financial Services and Markets Act 2000 (Banking Reform) (Pensions) Regulations 2015 (“the Pensions Regulations”) make provision to ensure RFBs are not, and cannot become, liable for the pension liabilities of other bodies (except RFBs in the same group or wholly owned subsidiaries of RFBs in the same group).

## **5. Extent and Territorial Application**

- 5.1 The extent of this instrument is England and Wales, Scotland and Northern Ireland.  
5.2 The territorial application of this instrument is the United Kingdom.

## **6. European Convention on Human Rights**

- 6.1 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, Core Activities, Excluded Activities and Prohibitions) (Amendment) Order 2016 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, chaired by Sir John Vickers, established in 2010 to make recommendations on the reforms necessary to avoid future financial crises. The government accepted the Independent Commission on Banking’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”). Further details of the ring-fencing regime were set out in secondary legislation (as described in the Legislative Context section above).
- 7.4 In the years since the secondary legislation was introduced, as banks have begun to implement the required structural changes, the Treasury has become aware of technical issues that, unless addressed, have the potential to undermine the effectiveness of the ring-fencing regime. In total these regulations are making 18 amendments. These are set out below:
- 7.5 The Pensions Regulations give banking groups until 2026 to separate their pension schemes. The Pensions Regulations also permit non-ring-fenced bodies (“NRFBs”) to provide funding support to RFB schemes, but do not allow for RFBs to reciprocate by providing funding support to NRFB schemes after 2026. This Order will make amendments to the EAPO to make it clear that the EAPO is consistent with the Pensions Regulations in these respects.
- 7.6 The Regulation of the European Parliament and the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms (“the Prudential

Requirements Regulation”) requires banks to hold a certain level of assets that fall within the category of high quality liquid assets. The ring-fencing legislation, as currently drafted, is inconsistent with this as it restricts the categories of high quality liquid assets that an RFB can buy. This Order will make amendments to the EAPO to ensure consistency with the Prudential Requirements Regulation.

- 7.7 RFBs are excluded from engaging in most trading activities but RFBs are allowed to trade assets from other RFBs and building societies to manage their liquidity risks. However, as it currently stands, the EAPO prevents RFBs trading covered bonds because the buying and selling of covered bonds necessarily involves incurring an exposure to a relevant financial institution (“RFI”). This Order will make amendments to the EAPO so as to allow an RFB to buy and sell covered bonds from other RFBs or building societies to manage their liquidity risks.
- 7.8 RFBs are generally required by the Prudential Regulation Authority (“PRA”) to be full members of any payment system to which they have direct access. This Order will allow RFBs to buy and sell shares in the operators of payment systems where this is a requirement of membership of the relevant system.
- 7.9 The PRA has indicated that RFBs should be direct members of clearing houses and central counterparties where they wish to access the services these entities provide. This Order will ensure that RFBs can deal in investments as principal where necessary in order to meet the conditions of membership of a central counterparty.
- 7.10 This Order will allow an RFB to hedge the risks of another entity in its ring-fenced sub-group. Permitting this will allow RFBs to manage risks more effectively across the RFB sub-group.
- 7.11 This Order will amend the definition of liquidity risk in the EAPO to allow an RFB to hedge the liquidity risks of its subsidiaries or financing vehicles.
- 7.12 When an RFB enters into a derivative transaction with an account holder it must ensure that its position risk (defined in the Prudential Requirements Regulation) falls within defined parameters set out in EAPO. This Order expands the factors that the RFB is required to consider, as it requires the RFB to also include foreign-exchange risk and commodities risk in the calculation determining whether its risk falls within the parameters set out in EAPO.
- 7.13 RFBs are currently prohibited from incurring exposures to Global Systemically Important Insurers (“G-SIIs”). The original statutory instrument was drafted before the Financial Stability Board had produced its list of G-SIIs. This list turned out to cover only the top companies of insurance groups, and not the insurer subsidiaries. These subsidiaries also pose a risk and exposures to them should also be restricted. This Order will therefore expand the existing prohibition to prohibit exposures to insurer subsidiaries of G-SIIs.
- 7.14 It is possible that an RFB could incur an exposure to an institution, which, while at the time was not an RFI, later becomes an RFI. This Order will allow an RFB in this situation a transitional period of 12 months in which to remove its exposure to the RFI.
- 7.15 Invoice financing is where funds are provided to a business that has issued an invoice and expects payment but has not yet received this payment. It is permitted under ring-fencing regulations. Syndicated financing is where multiple banks come together to make up a loan. It is also permitted. However, the EAPO as it stands prohibits

- syndicated invoice financing. This Order will amend the EAPO to allow syndicated invoice financing.
- 7.16 Some banks provide advisory or mentoring schemes for a fee. This could cover human resources issues and other regulatory requirements. The existing drafting of the EAPO prohibits such support to customers who are RFIs. This Order will introduce an exemption for this kind of advisory service.
- 7.17 Certain trustee services for retail clients are a recognisable and traditional element of retail banking, such as an RFB acting as a trustee for beneficiaries of wills. Acting in such capacity may require the RFB to deal in investments as principal on behalf of a client. This Order will permit an RFB to deal in investments as principal in a trustee capacity on behalf of individual account holders (including those acting on behalf of minors).
- 7.18 While RFBs are permitted to provide loans, the scale of and normal market practice for loans to infrastructure projects means these are normally provided through special purpose vehicles (“SPVs”). This is currently prohibited as a loan to an SPV is an RFI exposure. This Order will permit an RFB to provide financing to SPVs that are solely providing infrastructure funding directly to a specific project.
- 7.19 Larger corporate customers (turnover above £6.5m, balance sheet above £3.26m, or more than 50 employees) are currently required to submit a “qualifying declaration” before a bank can move their account to the NRFB. This imposes logistical challenges and creates an unnecessary administrative burden on medium and large businesses. This Order will remove the requirement for corporate depositors to complete a “qualifying declaration” and will instead require banks to reach a determination as to whether a customer is eligible to be moved to the NRFB. Banks will be required to inform customers of the bank’s determination as to the customer’s eligibility, the reasons for that determination, and that the customer may challenge this determination if it believes it to be mistaken.
- 7.20 NRFBs are required to provide information on ring-fencing to their account holders about banking outside the ring-fence. This requirement extends to account holders at branches of UK banks outside the EEA, account holders at UK-based branches of non-EEA banks and account holders who are not depositors (such as holders of mortgage accounts), notwithstanding the fact that the information in question will not be relevant to them. This Order will remove these unnecessary reporting rules.
- 7.21 The EAPO currently allows RFBs to enter into derivative transactions with account holders where certain conditions are satisfied. These include a requirement that the investments must fall into a specified category at the time the transaction was entered into. For historical derivative transactions, determining whether the investments in question fell within the relevant category on the date they were entered into will be disproportionately burdensome. This Order will therefore amend the EAPO to require RFBs to demonstrate that the relevant investments fell within the specified category on the day upon which the bank became an RFB, not on the date of the transaction.
- 7.22 RFBs are currently prohibited from securitising assets that they haven’t created themselves. To aid transition to the ring-fencing regime and strengthen the UK’s resolution toolkit, this Order amends the EAPO to allow an RFB to securitise assets acquired in a resolution scenario, transferred in a ring-fencing transfer scheme, or acquired by itself or a member of the wider banking group at least two years before

becoming an RFB. In all cases this is limited to assets that an RFB is permitted to hold.

### *Consolidation*

7.23 There are no plans to consolidate the relevant legislation.

## **8. Consultation outcome**

8.1 These amendments were subject to a short technical review with affected banking groups and their representative body, the British Bankers Association. This was proportionate for these amendments given their technical nature. These amendments have also been drafted in consultation with the Prudential Regulation Authority and the Financial Conduct Authority.

## **9. Guidance**

9.1 There are no plans to publish guidance. However the Treasury and the regulators are engaging with all of the affected banks on an individual basis to review their implementation plans.

## **10. Impact**

10.1 The removal of the qualifying declaration process will remove a burden on banks and their medium and large business clients.

10.2 Otherwise, these amendments respond to technical issues with the ring-fencing legislation and no new impact on business, charities or voluntary bodies is foreseen.

10.3 There is no impact on the public sector.

10.4 A regulatory impact assessment has not been prepared for this instrument. The Treasury is preparing a validation impact assessment in relation to the removal of the qualifying declaration process.

## **11. Regulating small business**

11.1 The legislation does not apply to activities that are undertaken by small businesses.

## **12. Monitoring & review**

12.1 Section 8 of the Financial Services (Banking Reform) Act 2013 requires the Treasury to establish an independent review of the operation of the ring-fencing legislation before 2021 (within two years of the ring-fencing rules fully coming into force). These amendments will be reviewed alongside the rest of the ring-fencing regime.

## **13. Contact**

13.1 Tom Etheridge at HM Treasury (Telephone: 0207 270 4522 or email: Tom.Etheridge@HMTreasury.gsi.gov.uk) can answer any queries regarding the instrument.