Title: Banking Reform: draft pensions regulations **IA No:** **Lead department or agency:** HM Treasury **Other departments or agencies:** Department for Business, Innovation and Skills	**Impact Assessment (IA)** **Date:** 24/11/2014 **Stage:** Final **Source of intervention:** Domestic **Type of measure:** Secondary legislation **Contact for enquiries:** banking.commission@hmtreasury.gsi.gov.uk

Summary: Intervention and Options

RPC Opinion: Awaiting Scrutiny

Cost of Preferred (or more likely) Option				
Total Net Present Value	**Business Net Present Value**	**Net cost to business per year** (EANCB on 2009 prices)	**In scope of One-In, One-Out?**	**Measure qualifies as**
-£61.06m	-£61.06m	£2.47m	No	NA

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

Ring-fencing will 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. The problem addressed is the negative impact on the real economy stemming from core deposit taking bodies within a banking group being unable to provide vital services as a result of failures within the broader group. It will also make ring-fenced retail banks simpler and easier for the authorities to resolve should they or their wider corporate groups fail. Ring-fencing will therefore reduce the likelihood of the Government being obliged to support a failing bank using public funds, and hence will curtail the perceived implicit government guarantee to systemic banks.

The Prudential Regulation Authority (PRA) is in the process of introducing rules on ring-fencing, including rules on the legal structure and governance of a ring-fenced body. In order to ensure effective separation it is necessary to prevent a ring-fenced body from becoming liable for pension liabilities arising elsewhere in the banking group. 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). As a result, 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 (granted under s142W FSMA).

What are the policy objectives and the intended effects?

The intended effect of ring-fencing and the overall policy objective is to ensure that ring-fenced banks can continue to operate in the event of the failure of other entities in the group. Under current pensions legislation, a ring-fenced bank may become liable for the pension burden of other members of the group in the event of their failure. This would undermine the effectiveness of the policy of ring-fencing. The intended effect of the Regulations is to ensure that ring-fenced banks are not, and cannot become, liable for pension liabilities of other bodies.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

One alternate option would be to do nothing (the Government would implement ring-fencing but not require the restructuring of pension liabilities). This would, however, leave a gap in the ring-fence whereby ring-fenced banks could become liable for costs in the case of a non-ring-fenced bank failing. This would undermine the benefits and the fundamental principles of ring-fencing. Furthermore this would be inconsistent with the other ring-fencing rules that the PRA are introducing, and indeed the recommendations of the Independent Committee on Banking. This would limit the positive impact of ring-fencing on financial stability and could therefore lead to a significant cost to the economy.

The preferred option is for the Regulations to prescribe the out come which is to be achieved but leave it to the banks and pension scheme trustees to decide how best to implement the changes required. During the consultation stakeholders broadly expressed approval for this non-prescriptive approach.

Will the policy be reviewed? It will be reviewed. **If applicable, set review date:** 01/2021

Does implementation go beyond minimum EU requirements?			N/A		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	**Micro** No	**< 20** No	**Small** No	**Medium** No	**Large** Yes
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:** N/A	**Non-traded:** N/A	

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 SELECT SIGNATORY: Andrea Leadsom Date: 23/11/2014

Summary: Analysis & Evidence

Policy Option 1

Description: Do Nothing: the Government implements ring-fencing, but does not require the restructuring of pension liabilities.

This option is used as a baseline for assessing the costs and benefits of Option 2 (require pension restructuring).

FULL ECONOMIC ASSESSMENT

Price Base Year	PV Base Year	Time Period Years	Net Benefit (Present Value (PV)) (£m)		
			Low: SEE TEXT	**High:** SEE TEXT	**Best Estimate:** SEE TEXT

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low	0		0	**0**
High	0		0	**0**
Best Estimate	0		0	**0**

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

None, as the Government implementing ring-fencing but not requiring ring-fenced banks to restructure their pension liabilities will impose no additional costs beyond those of other regulations currently in train. This option is used as a baseline for assessing the costs and benefits of Option 2 (require restructuring on ring-fenced banks' pension liabilities).

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

The requirement on ring-fenced banks to restructure their pension liabilities was included in the IA on the ring-fencing package as a whole. Reducing the probability and severity of future financial crises would produce an annual benefit equivalent to 0.54% of GDP, and the net benefit of the banking reform package is £145bn. Not implementing the full package of reforms would create a breach in the fence that could significantly undermine this. Therefore the do nothing approach is not without cost. This could result in significant cost to the economy should liabilities from outside the fence be passed onto a ring-fenced bank; limiting it's ability to provide vital services and potentially necessitating government intervention. This cost cannot be monetised.

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	0		0	**0**
High	0		0	**0**
Best Estimate	0		0	**0**

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

None, as the Government not implementing ring-fencing but not requiring banks to restructure their pension schemes will produce no additional benefits beyond those of other regulations currently in train. This option is used as a baseline for assessing the costs and benefits of Option 2 (require restructuring of ring-fenced banks' pension liabilities).

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

None, for the reasons given above.

Key assumptions/sensitivities/risks | **Discount rate (%)**

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: N/A	**Benefits:** N/A	**Net:** N/A	No	NA

Summary: Analysis & Evidence

Policy Option 2

Description: Proceed with the restructuring of ring-fenced banks' pension liabilities according to the provisions of the draft Banking Reform Pensions Regulations.

FULL ECONOMIC ASSESSMENT

Price Base Year 2013	PV Base Year 2015	Time Period Years 30	Net Benefit (Present Value (PV)) (£m)		
			Low: -79.45	**High:** -42.66	**Best Estimate:** -61.06

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	51.3	11	0.0	**42.7**
High	51.3		2.0	**79.4**
Best Estimate	51.3		1.0	**61.1**

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

Transitional administrative costs to large UK banks have been estimated at no greater than £50m spread across all affected banks, this cost will likely be spread over several years. Direct costs to regulator: ongoing costs to the PRA of no more than £2m p.a., transitional costs to the Pensions Regulator of £1.3m.

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

There are likely to be costs to large UK banks due to changes in the their schemes' 'employer covenants' due to the restructuring required by these regulations, as opposed to the corporate restructuring required under ring-fencing. These costs could be significant but are unquantifiable. These would be one off costs for affected banks that would be payable over a number of years.
There may be implications for UK banks of any section 75 payments required as a result of restructuring a multi-employer pension scheme. A section 75 payment will not increase a bank's overall liabilities, although there may be some administrative and practical costs for the banks of having to make these payments. Whether or not such payments will be needed depends largely on how trustees and banks chose to allocate assets and liabilities to new schemes or sections of schemes when carrying out this restructuring.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	SEE TEXT		SEE TEXT	**SEE TEXT**
High	SEE TEXT		SEE TEXT	**SEE TEXT**
Best Estimate	SEE TEXT		SEE TEXT	**SEE TEXT**

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

The marginal benefit of the Banking Reform Pensions Regulations in particular cannot be monetised. (See non-monetised benefits below)

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

Greater financial stability as a result of ring-fencing will benefit the UK economy as a whole. The previous IA estimated that reducing the probability of future crises by 10% and severity of future crises by 15% would produce an annual benefit equivalent to 0.54% of GDP (equivalent to £8.8bn in 2013 terms), and that the net benefit of the banking reform package is £145bn.
These pensions regulations are a non-trivial part of the total ring-fencing process. It is not however possible to separate out the financial stability benefits of this particular aspect of ring-fencing from the benefits of ring-fencing as a whole.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5%

Benefits: The reduction in the future probability and severity of financial crises as a result of ring-fencing.

BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: N/A	**Benefits:** N/A	**Net:** N/A	No	NA

Evidence Base

Introduction

1. The ring-fencing of retail from wholesale/investment banking is central to the Government's structural reforms of UK banks. Ring-fencing was a key recommendation of the Independent Commission on Banking (ICB), established in June 2010 and chaired by Sir John Vickers. Ring-fencing will 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. It will also make ring-fenced retail banks simpler and easier for the authorities to resolve should they or their wider corporate groups fail. Ring-fencing will thus reduce the likelihood of the Government being obliged to support a failing bank using public funds, and hence will curtail the perceived implicit government guarantee to systemic banks.

2. The ICB recommended ring-fencing after 18 months of deliberation, during which it considered a range of alternative structural reforms including full separation of retail from investment banking, narrow banking and full reserve banking. The ICB rejected these alternatives in favour of ring-fencing. Ring-fencing was also endorsed by the Parliamentary Commission on Banking Standards (PCBS), established in the summer of 2012.

3. The Government has accepted the ICB's recommendation, and is proceeding with ring-fencing. 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. Under current pensions legislation, as well as under some non-statutory arrangements, a ring-fenced bank could become liable for pensions of other entities in the event of their failure. The Financial Services and Markets Act (as amended by the Banking Reform Act) (FSMA) gives the Treasury the power to make regulations requiring UK banks to enact this required restructuring of pension schemes by 2026.

4. The requirement for ring-fenced banks to restructure their pension liabilities is set in secondary legislation: the Banking Reform Pensions Regulations. This IA sets out the cost and benefits of restructuring of pensions schemes in line with the draft Pensions Regulations, against the baseline of proceeding with ring-fencing without taking any steps to address ring-fenced banks' pension liabilities.

<u>Description of options considered</u>

Scope of this Impact Assessment

5. The Banking Reform Pensions Regulations are only one element of the larger ring-fencing package. Much of the legislation underpinning ring-fencing has already been made: the general principles of ring-fencing were established by the Financial Services (Banking Reform) Act 2013, and the detailed calibration of the ring-fence is set through the Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014 and the Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014.

6. Previous ring-fencing IAs compared the options of ‘implement ring-fencing’ and ‘do nothing’. This IA discusses the marginal cost of implementing the Pensions Regulations in addition to other ring-fencing measures. The main benefit, ensuring that the overall ring-fence is robust, cannot be monetised.

Option 1: Do nothing (the Government implements ring-fencing, but does not require the restructuring of pension liabilities)

7. Requiring large UK banks to restructure their pension liabilities is a necessary element of a wider ring-fencing package. In order to isolate the incremental impact of addressing ring-fenced banks pension liabilities in addition to wider ring-fencing measures, the Government has constructed a baseline ‘do nothing’ option, in which ring-fencing is implemented according to existing primary and subordinate legislation, but these Pensions Regulations are not made. For the purposes of this IA, the baseline is considered to have no costs and benefits, other than the non-monetised cost of the likely reduction in the total benefits of the existing ring-fencing legislation if the Government does not complete the reforms, including taking steps to address ring-fenced banks’ potential liabilities stemming from pension liabilities of other organisations outside of the ring-fence. This undermines the effectiveness of the ring-fence and would therefore present a greater, and potentially costly, risk to financial stability.

8. An IA on the Banking Reform Bill, including the ring-fencing primary and secondary ring-fencing legislation, can be found on the Government’s gov.uk website. The requirement on ring-fenced banks to restructure their pensions liabilities was included in this IA: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/223566/PU1488_Banking_reform_consultation_-_online-1.pdf. A further IA on the secondary legislation alone, using refreshed data, but without the costs and benefits of the requirements in these Regulations, is appended.

Option 2: Proceed with the restructuring of ring-fenced banks' pension liabilities according to the provisions in the draft Banking Reform Pensions Regulations.

9. Government policy is to proceed with ring-fencing. Much of the legislation underpinning ring-fencing has already been made. This IA covers the impact of the draft Banking Reform Pensions Regulations.

10. These Regulations implement the ICB recommendation that ring-fenced banks should be economically independent of the rest of their corporate group, and should not be liable for funding any deficit in any group-wide pension schemes. The Regulations achieve this by requiring ring-fenced banks to ensure that they are not, and cannot become, liable for the future pensions liabilities of entities which are not group ring-fenced banks (or wholly owned subsidiaries of group ring-fenced banks).

Costs of Option 2: Proceed with the restructuring of ring-fenced banks' pension liabilities according to the provisions in the draft Banking Reform Pensions Regulations.

Restructuring of bank pension schemes

11. These draft Banking Reform Pensions Regulations require ring-fenced banks to carry out the necessary restructuring so that they are not, and cannot become, liable for the future service pension liabilities of other group members (except other group ring-fenced banks, or wholly owned subsidiaries of group ring-fenced banks) or of outside companies. Liability to other pension schemes could either be a statutory liability, or a non-statutory liability, e.g. contractual guarantees issued by the ring-fenced bank to other group members' pension schemes.

12. It is important to understand that pension schemes can be valued in different ways. In particular they can be valued:

a. On an accounting basis - the amount required to buyout a pension scheme's liabilities with an insurer.

b. On a technical provisions basis - the amount required to ensure that the scheme will be able to pay its liabilities over the longer term assuming returns on scheme assets, as calculated by the pension scheme's trustees.

13. It is important to note that most of the large UK banks affected are currently running a deficit on an accounting basis and that all of the banks affected are currently running a deficit on an ongoing funding technical provisions basis. These deficits pre-date and are independent of the Government's ring-fencing proposals. Each bank is required to agree an appropriate plan of action to remove the ongoing technical provisions deficit in its pension scheme(s). Guidance issued by the Pensions Regulator (tPR) states that the aim should be to remove the technical provisions deficit over an appropriate period depending on employer and scheme circumstances. The costs to the large UK banks of meeting these existing deficits is not within the scope of this IA, which focuses solely on the impact of having to restructure existing pensions liabilities for the purposes of ring-fencing. However the banks' current payments to remove these existing deficits may interact with and delay any payments the banks need to make into their pension schemes as a consequence of ring-fencing.

<u>*The restructuring of pension schemes*</u>

14. The Government intends to give banks and their trustees a large degree of flexibility over how they undertake the restructuring required to ensure that ring-fenced banks are not liable, and cannot become liable, for the future service pension liabilities of group members or of outside companies accrued from 1 January 2026.

15. The Regulations will not prescribe the way banks and their trustees go about restructuring their pension schemes, instead, they will prescribe the outcome which is to be reached.

16. The route that the Government considers most likely to achieve the necessary restructuring of any multi-employer pension schemes that a ring-fenced bank has statutory liabilities in, is the “Splitting” of a scheme. Under this scenario, a second pension scheme is established with one or more employers having assets and liabilities transferred to it from the

existing scheme in a way that extinguishes their liability to the existing scheme. This would remove the potential for future liabilities of the non-ring-fenced bank to fall on the ring-fenced bank and vice versa.

17. The Government will not prescribe the proportion of the assets and liabilities that must stay in the ring-fenced bank's scheme, or section of a scheme. This will be left entirely at the discretion of the banks and their trustees.

18. The Government expects the banks and their trustees to determine the optimal solution for their respective schemes and to ensure that their pension scheme is restructured in a way that ensures the ring-fenced bank's economic independence. Given this flexibility, the details of the final form of how each scheme will be restructured cannot be predicted by the Government, (other than that it will have to meet the requirements detailed in the Regulations).

19. In addition, the Regulations require ring-fenced banks to ensure that they have no non-statutory liabilities, such as a contractual guarantee or bond, to the pension schemes of other organisations. This requirement is included largely as a safeguard, to prevent banks from setting up non-statutory arrangements which give rise to similar risks to statutory liabilities to multi-employer pension schemes.

Cost of separation

20. The Government believes there will be three principal costs of removing a ring-fenced bank's liability for the pension liabilities of other entities in its banking group:

Cost of separation - Impact on pension scheme covenant

21. The "employer covenant" is a term used to describe an employer's legal obligation to a pension scheme (or a section of a pension scheme) and its ability to fund the pension scheme now and in the future. The employer covenant is assessed by each scheme's trustees on a technical provisions basis. The stronger the employer covenant, the more investment risk that is likely to be acceptable to the pension scheme's trustees and the more optimistic the trustees may be about the assumptions they make for future investment returns from the assets of the scheme. A stronger covenant may therefore result in lower payments being agreed between trustees and employers although this does not change the total size of the pension scheme's obligations to members.

22. It is anticipated that employer covenants for each of ring-fenced and non-ring-fenced bank are likely to weaken after the corporate restructuring to separate the ring-fenced and the non-ring-fenced bank as each scheme, or section of a scheme, is now backed by fewer employers. To some extent these effects are likely to be offset by the fact that each scheme or section of a scheme will have fewer members and hence a lower value of liabilities and by the fact that the banks should have improved resilience following implementation of the Banking Reform measures. For example, ring-fenced banks will be better capitalised and insulated against global market shocks and this should reduce the probability of their becoming insolvent, which (all else being equal) would increase the strength of the employer covenant. The corporate restructuring required under ring-fencing, and any wider Banking Reform measures are not in scope of this IA.

23. As described above pension schemes can be valued in different ways, on an accounting basis or on a technical provisions basis. The change in the employer covenant alters the value of the pension scheme on a technical provisions basis (but not on an accounting basis). This

weakening of the employer covenant will mean that banks will have to increase contributions to their pension scheme. However banks' debts to pension scheme members will not increase and banks pension liabilities, as calculated on an accounting basis, will not increase.

24. It is not possible to accurately quantify the scale of the increase in banks' contributions to the scheme. How far the covenant is affected by these Regulations will depend on the exact details of how each scheme is restructured, which is highly uncertain and cannot be predicted in advance. In addition, the extent to which a weakening of the covenant will lead to higher contributions from the banks is dependent upon the negotiation between banks and their trustees, which is uncertain. However in order to provide a sense of scale we have looked at both the banks' accounts and banks' current pensions deficits and have talked to experts with experience of regulating UK pension schemes at tPR. This has suggested that the increased pension contributions will be in the low billions of pounds.

25. However, banks are required to hold a certain level of capital due to international capital requirements imposed on the banks. Banks' pension scheme deficits are considered on an accounting basis in calculations of Pillar 2a capital requirements. For the purposes of capital requirements, capital payments to pension schemes are normally capital neutral, because they result in a reduction in cash which is matched by a reduction in the accounting deficit.

26. This means that the cost to banks of making these pension contributions is small. The limit on how much banks are able to lend is based on their capital requirements. By paying into their pension schemes a bank is simply replacing a liquid asset which is of limited use to the banks, with a non-liquid asset that is also of limited use to the bank. So the bank is able to carry out roughly the same activity and lend the same amount regardless whether the capital is held by the bank or transferred to the pension scheme.

27. This means that the total cost to banks could be considered negligible except for two considerations:

a. Banks also need to manage their liquidity risk. By shifting cash into the pension scheme banks are reducing their access to liquid assets and reducing their liquidity. To meet liquidity requirements banks will have to account for the loss of liquidity swapping some other liquid assets for non-liquid assets. To date banks are finding ways that are not too expensive to swap liquid assets for non-liquid assets. Based on historical data the spread between the returns on liquid and non-liquid assets is 200 basis points.[1] This means that if a bank had to increase its pension contributions by an amount with a present value of £1billion, then this would cost £20m. Across all six banks we would therefore expect the cost of meeting these liquidity requirements to be in the high tens of millions or the very low hundreds of millions.

b. A bank's capital position may be affected where the technical provisions deficit is in excess of the accounting deficit. Where this is the case, payments made to the scheme to fund it to a level where it has a surplus on an accounting basis may be capital reducing. This is because pension surpluses (calculated on the accounting basis) are generally not available as capital for banks. Payments to the scheme to reduce an accounting deficit are capital neutral, because they result in a reduction in cash which is matched by a reduction in the accounting deficit. Banks are going to look to avoid the situation where their pension schemes are in surplus and we see

[1] This figure of 200 basis points is taken from the European Banking Authority LCA impact assessment of 2013: "Report on impact assessment for liquidity measures under Article 509(1) of the CRR", 20th December 2013, Section 3.4.2. "Liability-side adjustments", page 115, http://www.eba.europa.eu/documents/10180/16145/EBA+BS+2013+415+Report+regarding+LCR+impact.pdf.

this is an unlikely scenario. We think that the expected value of costs here will be minimal.

28. The weakening of the employer covenant will only affect banks' handling of defined benefit pension schemes and banks no longer offer such schemes, so any costs arising from employer covenant changes would not be ongoing. There is no time limit on deficit payment plans which sometimes last over ten years. We would expect pension contributions arising from employer covenant changes to be paid off over a period of time negotiated between the bank and the trustees. Also such payments may be further delayed due to payments banks are already planning to make to eliminate their technical provisions deficits. Therefore any costs arising from changes to the employer covenant can be considered as a transitional cost that banks will face over the next 10 to 20 years.

29. We expect the present value of any cost arising from changes to the employer covenant to be on the scale of the tens of millions. However as explained above, given the high degree of uncertainty, we do not believe it is possible for the Government to predict these costs with any degree of accuracy and so they have not been monetised in this IA.

Cost of separation - Initial separation cost

30. Under Section 75 of the Pensions Act (1995), an employer withdrawing from a pension scheme which is in deficit, or a section of such a scheme, may be required to pay into the scheme compensation for giving up its previous liabilities to the scheme. This is known as the section 75 debt.[2] This payment reflects the fact that the employer will no longer be making payments into the scheme in the future.

31. Triggering section 75 payment does not increase the overall liability for a bank. It could lead to one part of the overall banking group making a large payment to the pension scheme of another part of the banking group. For example the ring-fenced bank may have to pay into the non-ring-fenced bank's pension scheme or visa-versa. This payment may be sizable as it would be a share of the total funding deficit of the scheme and the funding deficit of the banks' pensions schemes is in the billions of pounds (for example the total funding deficit for Barclays is £11.6 billion). The cost to the banking group as a whole of having to pay a section 75 debt would be:

a. The short term administration costs of having to make the payment (these are included in the total approximation of administration costs below).
b. Any impact on the underlying business of the group. Given the size of the payment one part of the banking group may end up with non-ideal amounts of capital and this could impact the group's business.

32. Section 75 debts will not necessarily be triggered, as this depends on the restructuring route chosen by the bank and trustees.

33. The exact level of the section 75 payment would depend on details of how each pension scheme was restructured, and the resulting negotiation between banks and their trustees on the value of any payment required. If the departing employer takes with it some or all of its previous liabilities (into a new scheme or section), its section 75 debt may be reduced by a 'relevant transfer deduction'. If the departing employer took its full share of the existing scheme's liabilities, the section 75 payment is likely to be nominal.

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[2] http://www.thepensionsregulator.gov.uk/guidance/multi-employer-schemes-and-employer-departures.aspx

34. Given the uncertainties involved about whether section 75 debts will be triggered and about the size of such debts, it is not possible for the Government to quantify the cost to the banks of meeting theses debts, so this cost has not been monetised in this IA. However as section 75 debts are primarily a movement of money within a group we do not expect this cost to be sizable.

Cost of separation - Administrative cost

35. There will be one-off costs associated with the segregating or splitting of the liabilities to the pension scheme, including costs such as legal, actuarial and administration fees. Estimates provided by the large UK banks and the trustees of their pension schemes suggest this impact would be no greater than £50m across all the affected banks in relation to the ring-fencing of the pension liabilities. In order to give banks more time to ensure appropriate arrangements for the separation of pension schemes, the obligation to have the pension arrangements required by these Regulations in place will not come into force until 1st January 2026, so this cost will likely be spread over a decade.

Other costs

Expected finance and resource impact on the regulators

36. Enforcing and policing the ring fence will incur costs to the PRA. The FSA estimated that the upfront cost to the regulator of implementing the ICB's recommendations (including ring-fencing) was no more than £20m, with subsequent ongoing costs of around £2m per annum. The upfront costs will be due to implementing other aspects of the ICB's recommendations, such as the making of ring-fencing rules, which are not in scope of this IA. As this cost will be somewhere in the range of £0m to £2m this IA has taken a mid-range estimate of the ongoing cost to the PRA of around £1m per annum.

37. Enforcing the Banking Reform Pensions Regulations will also incur costs to tPR, as they will have to process the applications for clearance associated with any restructuring undertaken to comply with these Regulations and with ring-fencing as a whole. TPR have estimated that the overall additional resource cost to them would be in the region of £1.3m. This is based on making assumptions about how often each of the 6 banks currently in scope of ring-fencing are likely to apply for clearance, and about the expected cost to tPR of handling these clearance applications.

Benefits of Option 2: Proceed with requiring ring-fenced banks to restructure their pension liabilities

38. Ring-fencing ensures that ring-fenced banks carrying out core services are more resilient, and more resolvable. The principle behind ring-fencing is that ring-fenced bodies must be separately capitalised and as far as reasonably practicable, be legally, financially and operationally independent from the rest of their corporate group.

39. Requiring ring-fenced banks to ensure that they are not, and cannot become, liable for the pension liabilities of other bodies is just one element of a wider package of measures that will ensure that ring-fenced banks are sufficiently separate from the rest of their corporate group.

40. This separation of pension liabilities is fundamental to the effectiveness of ring-fencing. Without this separation there would be a gap in the ring-fence and a clear risk of the viability of a healthy ring-fenced bank being threatened by extra pension liabilities in the event of failure of another group member.[3] This would undermine the benefits and the basic principles of ring-fencing and would be out of line with the other ring-fencing rules that the PRA are introducing.

41. The IA on ring-fencing as a whole estimated the annual economic benefit of greater financial stability to be 0.54% of GDP (equivalent to £8.8bn in 2013 terms), and the net benefit (PV) of ring-fencing as a whole to be £145 billion. The requirement for ring-fenced banks to restructure their pension liabilities was included in this IA. The Banking Reform Pensions Regulations therefore protect this benefit by ensuring that the ring-fence is robust. Full details of how these benefits were assessed can be found in the IA on the Banking Reform Bill and subordinate ring-fencing legislation: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/223566/PU1488_Banking_reform_consultation_-_online-1.pdf, and in the updated IA on the secondary legislation, which is appended.

42. Unfortunately it is not possible to separate out the benefits of this particular aspect of ring-fencing from the benefits to financial stability of ring-fencing as whole. However by noting that the separation of pension liabilities is a significant and non-trivial part of the ring-fence we can say that we expect the likely scale of the impact will be significant. Banks' pension liabilities are in the tens of billions of pounds and an unexpected pension liability falling on a ring-fence bank could be disastrous to the safety of that bank. If pension liabilities from outside of the ring-fenced bank are allowed to threaten the viability of the bank then the principles of ring-fencing, and the insulation provided to the vital services essential to the real economy, would be undermined.

Conclusion on costs and benefits

43. Ring-fencing will increase the resilience and resolvability of UK banks, and will thus reduce both the likelihood and the severity of future financial crises. Implementing the restructuring of bank pension schemes will protect the benefits of ring-fencing. These benefits cannot be monetised but are likely to be significant and in the order of magnitude of billions of pounds.

44. There are monetised transitional costs to banks with a net present value of -£61.06m. There are also un-monetised transitional cost to the banks as a result of handling potential Section 75 payments and as a result of changes to the bank's employer covenant. Although these costs cannot be monetised rough calculations suggests that the cost of these changes on the banks will likely be the order of magnitude of tens of millions of pounds, primarily as a result of the changes to employer covenants.

45. As these costs and benefits cannot be monetised, this IA gives a net present value of -£61.06m.

46. Viewing this figure and the scale of the un-monetised costs to banks against the benefits of ring-fencing as a whole to financial stability, and given that financial crises are known to be very costly and that only relatively modest improvements in UK financial stability are needed in

[3] It was such an involuntary obligation that forced the charitable Wedgwood Museum Trust into administration following the failure of the broader Wedgwood group (see: http://www.museumsassociation.org/museumsjournal/news/26042010-wedgwood-museum-trust-in-administration).

order to yield very substantial economic benefits, **the Government concludes that the benefits of proceeding with ring-fencing by implementing the Banking Reform Pensions Regulations outweigh the costs**. The Government is therefore proceeding with implementing the Banking Reform Pensions Regulations.

Rationale for the level of analysis in this Impact Assessment

Proportionality

47. The draft Banking Reform Pensions Regulations are one part of a wider package of legislation implementing ring-fencing.

48. Ring-fencing is the product of extensive policy development and consultation by both the ICB and the Government over a period of more than 2 years. During this period, a wide range of alternative approaches have been considered, including alternative models for structural reform of banks (e.g. full separation of retail and investment banking, full reserve banking and narrow banking considered by the ICB) and different options for the calibration of the ring-fence and depositor preference (e.g. alternative calibrations considered for the Government's Banking Reform White Paper).

49. The general principles of ring-fencing were established by the Financial Services (Banking Reform) Act 2013 ("the Banking Reform Act"). The IA on the ring-fencing measures in the Banking Reform Bill can be found here: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/228995/8545.pdf

50. The Government has made two Orders under FSMA, which set the detailed calibration of the ring-fence: the Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014; and the Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014. An IA on these two draft Orders, plus the ring-fencing measures inserted into FSMA by the Banking Reform Act, can be found here: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/223566/PU1488_Banking_reform_consultation_-_online-1.pdf

51. The impact of the existing ring-fencing legislation has been assessed in these previous IAs. This IA focuses exclusively on the impact of the draft Banking Reform Pensions Regulations, which have been compared to a 'Do Nothing' alternative of continuing with ring-fencing according to the legislation already in place, without making these Pensions Regulations.

Impact on the remuneration and pension schemes of employees at the banks

52. There is a risk that members of relevant pension schemes are detrimentally affected by these changes. For example there is a possibility that, depending on how banks restructure their pension schemes, members could lose out on traditional tax protections. In order to minimise this risk the standard system of checks and balances will apply, as well as an additional requirement for the banks to apply for clearance from the Pensions Regulator. We therefore expect the impact on employee's pensions to be minimal.

53. Alternatively banks could try to pass costs on to their employees by reducing overall remuneration levels. We believe that the impact here is unlikely to be significant, as there are a

number of ways that banks could choose to handle any additional costs. This would be a commercial decision for each bank, which it is not possible for the Government to forecast with any certainty.

Wider impacts

54. There are a number of wider impacts that have been considered. These are detailed below.

Distribution of the impact in the market

55. The cost to each bank in the industry as a result of these Pension Regulations will be different, as the profile of their pension schemes, and their plans for ring-fencing as a whole, are different. The Government is allowing banks and their trustees as much flexibility as possible in how they restructure their pension liabilities to meet the requirements of ring-fencing, which gives them scope to find an optimal solution.

Small and Micro Business Assessment

56. This policy does not directly apply to any Small or Micro Businesses, and these businesses will remain unaffected. There are two ways that Small and Micro Businesses may be indirectly affected.

57. This policy may distort business borrowing. An increase in banks' private costs may lead to an increase in lending costs. Larger businesses that are not reliant upon funding through these banks, and can access funds from alternative sources, would be less affected by the increase in bank lending costs than smaller businesses that may be more dependent on funding from banks. Whether and how banks choose to pass on additional costs to their customers is a commercial decision for each bank, which it is not possible for the Government to forecast with any certainty. We expect the impact of this to be minimal as there are other ways for the banks to offset these costs. The banks will still need to offer funds at competitive rates, as this measure only affects the 6 largest UK banks, and as there are other ways and other institutions that small businesses can turn to for credit.

58. Ring-fencing is expected to have a positive impact on competition in the UK banking sector. Reducing the perceived implicit government guarantee for large UK banks that are seen as 'too big to fail' should support competition in the UK banking sector, as the perceived implicit guarantee gives a competitive advantage to large banks over smaller competitors, who are not seen as benefiting from an implicit guarantee. Reducing the perceived implicit guarantee will thus reduce the competitive disadvantage for smaller banks and should support greater competition in the market, to the benefit of both Small and Micro Businesses.

59. Overall, then, the net effect of the policy on Small and Micro Businesses is unclear but unlikely to be very significant. As a result, we believe that there is no proportionate scheme is required for offsetting the burden of this uncertain cost (if indeed it is a cost) on Small and Micro Businesses.

Impact on competitiveness of UK banking sector

60. The Government believes that ring-fencing will enhance competitiveness in the UK financial sector in the long run, through greater financial and macroeconomic stability. It is

imperative that such regulatory reform is introduced to make the UK banking sector more stable and intervention at the taxpayers' expense less likely in future.

Equality impact

61. The Government has considered its obligations under the Equalities Act 2010. The Government does not believe these measures will impact upon discrimination, equality of opportunity or good relations towards people who share relevant protected characteristics under that act.

62. The Government considers that the proposals are compatible with the Convention rights protected under the Human Rights Act 1998.

Rational for considering measure to be out-of-scope of One In, Two Out (OITO)

63. This measure is a financial systemic risk measure. The primary aim of this measure is to protect core financial services from shocks occurring in elsewhere in the global financial system, making ring-fenced banks more resolvable, and allowing for core services to be kept running. This falls under the OECD (2004) definition of financial systemic risk and therefore this measure is out-of-scope of the OITO.

Summary and implementation plan

Chosen policy option

64. The Government proposes to Proceed with the the restructuring of ring-fenced banks' pensions liabilities according to the provisions of the draft Banking Reform Pensions Regulations. (Option 2). The Government believes that implementing these measures will deliver net benefits relative to the baseline (Option 1).

Implementation plan

65. The Government has already made the majority of legislation required to implement ring-fencing. The Government now intends to lay the Banking Reform Pensions Regulations before Parliament in early 2015. The deadline for banks to comply with ring-fencing is 2019, and the deadline for banks to have made the required changes to their pension liabilities is 2026.

Post-implementation review

66. The Government has committed to review the ring-fencing legislation in 2021. This measure will be reviewed alongside the rest of the ring-fencing in 2021. It is impossible to say how many of the banks will have restructured their pension schemes at this time. It will be decide in 2021 whether this measure requires a further review at a later date.

Appendix: June 2014 Impact Assessment on ring-fencing secondary legislation

Title: Banking Reform: Ring-fencing secondary legislation IA No: Lead department or agency: HM Treasury Other departments or agencies: Department for Business, Innovation and Skills	Impact Assessment (IA) Date: 05/06/2014 Stage: Final Source of intervention: Domestic Type of measure: Secondary legislation Contact for enquiries: banking.commission@hmtreasury.gsi.gov.uk

Summary: Intervention and Options

RPC Opinion: GREEN

Cost of Preferred (or more likely) Option				
Total Net Present Value	**Business Net Present Value**	**Net cost to business per year** (EANCB on 2009 prices)	**In scope of One-In, One-Out?**	**Measure qualifies as**
£145,000m	£m	£m	No	NA

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

Structural reform of UK banks is necessary to tackle the 'too big to fail' problem: banks that are large, systemic and too complex for their failure to be safely managed without serious economic consequences or recourse to public funds are perceived to benefit from an implicit government guarantee. This represents an anti-competitive subsidy to large banks, creates moral hazard and places a perceived contingent liability on the taxpayer. The UK Government, along with G20 partners, has committed to removing any implicit guarantees to the banking system.

What are the policy objectives and the intended effects?

The policy objective is to curtail the perceived implicit government guarantee enjoyed by banks seen as 'too big to fail' by making UK banks more resilient to shocks and more resolvable in the event of failure. This is to be achieved by requiring the ring-fencing of retail deposit-taking services (whose continuous provision is essential for financial stability and the wider economy) from wholesale/investment banking. This will insulate essential retail banking services from shocks originating elsewhere in the financial system, and by making banks more resolvable ensure that the continuity of these services can be maintained in the event of bank failure. This will reduce the likelihood of public funds being needed to rescue a failing bank.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

Ring-fencing secondary legislation is the latest step in a process of policy development that began with the establishment of the Independent Commission on Banking (ICB) in June 2010. The ICB examined a range of options for structural and non-structural reform to tackle the 'too big to fail problem', including full separation of retail from investment banking, narrow banking and full reserve banking. In its final report in September 2011, the ICB rejected these alternatives in favour of ring-fencing, which it recommended.
The Government accepted the ICB's recommendation in December 2011. The Government has consulted on different options for the precise calibration ofthe ring-fence, including a White Paper in 2012, and consultation on draft ring-fencing secondary legislation in 2013. Following this process, the Government has now formed a final policy position on the calibration of the ring-fence. This policy (set out in final ring-fencing secondary legislation) represents the best balance between financial stability and wider economic costs.

Will the policy be reviewed? It will be reviewed. **If applicable, set review date:** 01/2021

Does implementation go beyond minimum EU requirements?			No		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	**Micro** No	**< 20** No	**Small** No	**Medium** Yes	**Large** Yes

What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)	**Traded:** N/A	**Non-traded:** N/A

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) that the benefits justify the costs.

Signed by the responsible Minister: Andrea Leadsom Date: 05/06/2014

Summary: Analysis & Evidence

Policy Option 3

Description: Do Nothing: the Government does not implement ring-fencing of retail from investment banking. This option is used as a baseline for assessing the costs and benefits of Option 2 (proceed with ring-fencing)

FULL ECONOMIC ASSESSMENT

Price Base Year	PV Base Year	Time Period Years 30	Net Benefit (Present Value (PV)) (£m)		
			Low: 0	**High:** 0	**Best Estimate:** 0

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	0		0	**0**
High	0		0	**0**
Best Estimate	0		0	**0**

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

None, as the Government not implementing ring-fencing will impose no additional costs beyond those of other regulations currently in train. This option is used as a baseline for assessing the costs and benefits of Option 2 (proceed with ring-fencing).

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

None, for the reasons given above.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0		0	**0**
High	0		0	**0**
Best Estimate	0		0	**0**

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

None, as the Government not implementing ring-fencing will produce no additional benefits beyond those of other regulations currently in train. This option is used as a baseline for assessing the costs and benefits of Option 2 (proceed with ring-fencing).

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

None, for the reasons given above.

Key assumptions/sensitivities/risks | **Discount rate (%)**

BUSINESS ASSESSMENT (Option 3)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: N/A	**Benefits:** N/A	**Net:** N/A	No	NA

Summary: Analysis & Evidence
Policy Option 4

Description: Proceed with the ring-fencing of retail from wholesale/investment banking, according to the provisions of the ring-fencing secondary legislation.

FULL ECONOMIC ASSESSMENT

Price Base Year 2013	PV Base Year 2019	Time Period Years 30	Net Benefit (Present Value (PV)) (£m)		
			Low: SEE TEXT	**High:** SEE TEXT	**Best Estimate:** 145,000

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	500	2	440	**8,500**
High	3,000		2,150	**41,000**
Best Estimate	1,750		1,190	**22,600**

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

Direct private costs to affected UK banks of £1.8bn-£3.9bn p.a. Direct costs to regulator: £20m (up front), £2m p.a. Indirect cost to GDP from banks passing on increased private costs to customers: reduction in long-run GDP level of 0.04%-0.18% (equivalent to average annual GDP cost of £0.4bn-£2.2bn p.a.). Indirect Exchequer impact: reduction in tax receipts of £150m-£750m p.a. and reduction in value of HMG shareholdings in RBS and Lloyds Banking Group of £0.9bn-£3.5bn, relative to baseline.

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

Indirect cost to bank customers through changes in lending and saving rates.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	SEE TEXT		SEE TEXT	**SEE TEXT**
High	SEE TEXT		SEE TEXT	**SEE TEXT**
Best Estimate	SEE TEXT		8,800	**167,500**

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

Benefit to UK economy as a whole from greater financial stability. Fewer and less severe financial crises in future expected to lead to higher levels of long-run GDP.
Illustrative calculation shows that reducing probability and severity of future crises by 40% would produce an annual economic benefit equivalent to 1.81% of GDP (£29.3bn in 2013-14 terms). If ring-fencing accounted for 25% of this effect, the annual economic benefit would be 0.54% of GDP (£8.8bn in 2013 terms).

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

UK retail banking services will be better insulated against financial shocks, and resolution authorities will be better able to manage the failure of systemic banks without recourse to public funds. This will reduce the perceived contingent liability on the taxpayer, supporting lower sovereign borrowing costs.
Removing implicit subsidies to banks seen as 'too big to fail' will increase economic efficiency and GDP. Greater economic stability also brings welfare benefits independent of GDP level.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

Costs: How far banks pass through increased private costs from ring-fencing to customers (rather than internalising private costs), and the subsequent impact on GDP.
Benefits: The reduction in the future probability and severity of financial crises as a result of ring-fencing.

BUSINESS ASSESSMENT (Option 4)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: N/A	**Benefits:** N/A	**Net:** N/A	No	NA

Evidence Base

Introduction

67. The financial crisis of 2007-09 revealed the urgent need for 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. This creates moral hazard, incentivising excessive risk-taking, places perceived contingent liabilities on the taxpayer, and acts as an anti-competitive implicit public subsidy to the largest banks. Following the 2007-09 crisis, the UK Government, along with G20 partners, committed to eliminating implicit guarantees to the banking sector. To deliver on this commitment, the Government has embarked on a wide-ranging package of financial sector reform, including the overhaul of the regulatory architecture, the introduction of resolution regimes for banks and other financial institutions, as well as structural reforms of the UK banking sector. Alongside these changes, the Government has implemented reforms to address failings in the culture and conduct of UK banks that emerged during and after the 2007-09 crisis.

68. The ring-fencing of retail from wholesale/investment banking is central to the Government's structural reforms to UK banks. Ring-fencing was a key recommendation of the Independent Commission on Banking (ICB), established in June 2010 and chaired by Sir John Vickers. Ring-fencing will 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. It will also make ring-fenced retail banks simpler and easier for the authorities to resolve should they or their wider corporate groups fail. Ring-fencing will thus reduce the likelihood of the Government being obliged to support a failing bank using public funds, and hence will curtail the perceived implicit government guarantee to systemic banks.

69. The ICB recommended ring-fencing after 18 months of deliberation, during which it considered a range of alternative structural reforms including full separation of retail from investment banking, narrow banking and full reserve banking. The ICB rejected these alternatives in favour of ring-fencing. Ring-fencing was also endorsed by the Parliamentary Commission on Banking Standards (PCBS), established in the summer of 2012.

70. The Government has accepted the ICB's recommendation, and is proceeding with ring-fencing. The ring-fence is being implemented through a combination of primary and subordinate legislation. The general principles of ring-fencing are established by the Financial Services (Banking Reform) Act 2013. The detailed calibration of the ring-fence is set in secondary legislation: the Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014 determines what entities are subject to ring-fencing and what activities must be within the ring-fence; the Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014 determines what activities must be outside the ring-fence. The relationship between ring-fenced banks and the rest of their corporate groups will be governed by rules made by the regulators.

71. The Government published draft ring-fencing secondary legislation for consultation in July 2013. Having considered responses to that consultation, the Government has finalised the details of ring-fencing policy and is now making the Ring-fenced Bodies and Core Activities Order and the Excluded Activities and Prohibitions Order. This impact assessment sets out the estimated costs and benefits of the measures in those two Orders.

Description of options considered

72. As this is a final stage impact assessment, only the Government's final policy is considered, and its impact estimated relative to a 'do nothing' baseline.

Option 1: Do nothing (baseline)

73. Ring-fencing is one element of a wider package of financial sector reforms introduced since the 2007-09 crisis, which also includes:

- reform of the financial services regulatory system through the Financial Services Act 2012;
- tougher capital and liquidity standards set by the Basel III Accord (implemented in the EU through the Capital Requirements Directive (CRD 4) and Capital Requirements Regulation (CRR)) and including capital surcharges for Globally Systemically Important Banks (G-SIBs) set by the international Financial Stability Board (FSB); and
- establishment of a resolution regime for banks and financial institutions, including through the EU Bank Recovery and Resolution Directive (BRRD).[1]

74. In order to isolate the incremental impact of ring-fencing in addition to these wider reforms, the Government has constructed a 'do nothing' option, in which ring-fencing is not implemented, but wider regulatory reforms are. This will serve as a baseline for estimating the incremental costs and benefits of ring-fencing. For the purposes of this impact assessment, the baseline is considered to have no costs and benefits relative to itself.

[1] More details on these wider regulatory reforms are available at the following links:
Financial Services Act 2012: http://www.legislation.gov.uk/ukpga/2012/21/contents/enacted
Basel III Capital Requirements and Globally Systemically Important Banks (G-SIB) Surcharge:
http://www.bis.org/publ/bcbs189.pdf and http://www.bis.org/publ/bcbs207.pdf
FPC Macroprudential Powers: http://www.bankofengland.co.uk/financialstability/Pages/fpc/default.aspx
EU Banking Recovery and Resolution Directive:
http://register.consilium.europa.eu/doc/srv?l=EN&f=PE%2014%202014%20INIT
Special Resolution Regime:
http://www.bankofengland.co.uk/financialstability/Pages/role/risk_reduction/srr/default.aspx

Option 2: Proceed with ring-fencing

75. Government policy is to proceed with ring-fencing.

76. The general principles of ring-fencing were established by the Financial Services (Banking Reform) Act 2013 ("the Banking Reform Act"), which created the concepts of 'ring-fenced bodies', 'core activities' (activities that must be within the ring-fence) and 'excluded activities' (activities that must be outside the ring-fence). The Government is now making two Orders under the Banking Reform Act, which set the detailed calibration of the ring-fence. These Orders are:

- the Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014 ("the Ring-fenced Bodies and Core Activities Order"); and
- the Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014 ("the Excluded Activities and Prohibitions Order").

Key parameters of ring-fence calibration

77. The key parameters of the ring-fence, as set in the two Orders, are as follows:

- **Scope of the ring-fence**: Ring-fencing applies to all banking groups with total retail deposits of £25 billion or more. Banks below this threshold are exempt from ring-fencing.

  Core activities: Accepting 'core deposits' is a core activity, which may only be undertaken by ring-fenced banks (or exempt banks).

  'Core deposits' are those of individuals (other than high-net-worth individuals (HNWIs)) and small businesses. HNWIs and large organisations will have the option (but no obligation) to deposit outside the ring-fence if they choose to do so.
- **Excluded Activities**: The regulated activity of dealing in investments as principal (trading in financial investments across a bank's own balance sheet) is an excluded activity, which may not be carried on by ring-fenced banks.

  Exceptions to the excluded activity of dealing in investments as principal permit ring-fenced banks to deal in investments for the purpose of managing their own risks, and to sell simple derivatives (including a narrow range of simple options) to their customers.

  Dealing in physical commodities, such as precious metals, oil or agricultural produce, is an excluded activity, which may not be carried on by ring-fenced banks.
- **Prohibitions**: Ring-fenced banks are prohibited from having exposures to financial institutions, including non-ring-fenced banks, investment firms, systemic insurers and investment funds.

  Exceptions to the prohibition on financial institution exposures permit ring-fenced banks to provide trade finance services and payments services to their customers.

  Ring-fenced banks are prohibited from having branches or subsidiaries outside the EEA.

Measures not included in this impact assessment

78. This impact assessment only covers the implementation of ring-fencing, according to the provisions of the two ring-fencing Orders listed above. It does not include other recommendations of the ICB or other provisions of the Banking Reform Act (such as the introduction of a bail-in power or depositor preference). As a result, the figures given here for the total impact of ring-fencing are not the same as those given in previous impact assessments of the entire ICB package or of the Banking Reform Act, which were wider in scope.

79. This impact assessment also does not include the impact of restructuring of banks' pension schemes consequential to ring-fencing. Requirements for banks' pension schemes following ring-fencing will be the subject of separate banking reform pensions regulations, which will be accompanied by a separate impact assessment.

Costs and benefits

80. The costs and benefits of the two policy options included in this impact assessment (estimated relative to the 'do nothing' baseline) are summarised in the table below.

Option 1: 'Do nothing' baseline
Zero (baseline has no incremental costs and benefits relative to itself)
Option 1: Proceed with ring-fencing
<u>Costs (gross)</u>: Aggregate private costs to affected UK banks: £1.8bn-£3.9bn per annum (ongoing); £0.5bn-£3bn (one-off transitional); Social cost to UK economy: Reduction in long-run GDP level of **0.04%-0.18%**; (equivalent to annual GDP cost of £0.4bn-£2.2bn); (present value gross GDP cost: £8.5bn-£41bn); Cost to public finances (Exchequer cost): Reduction in tax receipts: £150m-£750m per annum; Reduction in value of Government shareholdings in partially publicly-owned banks: £0.9bn-£3.5bn.
<u>Benefits (gross)</u>: Illustrative calculation of economic benefit of increased financial stability: Annual economic benefit of **0.54% of GDP**; (equivalent to £8.8bn in 2013 terms); (present value gross GDP benefit: £167.5bn). <u>Non-monetised benefits</u>: Improved resilience and resolvability of UK banks will curtail perceived implicit government guarantees, and thus reduce moral hazard and incentives for banks to take excessive risks. Greater financial stability will support greater economic stability. Curtailing the perceived implicit government guarantee will reducing the Government's contingent liabilities to the banking sector, supporting lower Government borrowing costs.

Costs of Option 2: Proceed with ring-fencing

81. The Government's estimates of the costs of implementing ring-fencing are set out in the following sections, beginning with a general discussion of how costs arise, followed by descriptions of how the Government has modelled the costs of ring-fencing to banks (private costs), GDP (social costs) and the public finances (exchequer costs) respectively. As the benefits of ring-fencing accrue to the economy as a whole, the costs to GDP are the appropriate comparator, and are used for net cost/benefit calculations in this impact assessment. It is important to note that the costs set out in this section are **gross costs**, i.e. they take no account of the benefits of ring-fencing, which are discussed at paragraphs 55-63 below.

Overview: how costs arise

82. The first round impact of ring-fencing will be an increase in the private costs faced by affected UK banks. The second round impact will be that on GDP produced as a result of those private costs.

Private costs to affected UK banks

83. The private cost of ring-fencing to UK banks is generated by the curtailment of perceived implicit government guarantees, and by the frictional (operational) costs of structural separation of retail from investment banking.

84. The principal economic cost to UK banks of ring-fencing comes from the **reduction in the perceived implicit government guarantee** enjoyed by banks seen as 'too big to fail'. To the extent that investors believe that the government would not be willing to allow a bank to fail, that bank enjoys a perceived implicit guarantee. This acts to lower the bank's cost of funding as well as the level of capital that the market requires of it. The perceived implicit guarantee thus acts as an implicit subsidy to banks seen as 'too big to fail': academic estimates of the value of the perceived implicit guarantee range from £6bn to £100bn per annum.[2]

85. Ring-fencing is not the only policy measure intended to curtail the perceived implicit guarantee. Higher capital and liquidity requirements have contributed to this objective, by making banks less likely to fail. Similarly, the introduction of resolution regimes has sent a strong signal to the market that banks should not in future expect to benefit from taxpayer-funded bail-outs, though there is no consensus on the extent to which this has already been priced in by the market. Ring-fencing is complimentary to these other reforms, and will curtail the perceived implicit government guarantee by making UK banks more resilient and resolvable.

86. In addition to the reduction of the perceived implicit guarantee, there will be some **frictional costs of structural separation**, from a reduction in the diversification of banks' business models and potentially their ability to cross-sell retail and wholesale banking services to their customers. The value of the benefit universal banks currently receive from diversification is, however, debated and the ICB struggled to quantify it. In addition to the cost of this loss of diversity, banks will face ongoing administrative costs of operating additional legal entities (such as the costs of operating separate IT platforms), and upfront costs of restructuring (such as the costs of establishing new subsidiaries.

[2] 'The Implicit Subsidy to Banks', *Financial Stability Paper* 15, Bank of England, May 2012.

Social cost to UK economy

87. In the first instance, an increase in banks' costs will have little or no impact on GDP as these costs to banks create benefits to other agents in the UK economy. For example, a rise in the cost of wholesale funding will represent an increase in a cost to banks, but also an increase in income to bank creditors. If there were no change in behaviour from this re-pricing of bank wholesale funding, there would be no change in GDP.

88. The impact on GDP materialises as banks, individuals and businesses change their behaviour in response to this transfer of costs. Faced with higher private costs, banks may pass through costs on to customers by increasing the price of credit they extend to individuals and businesses. This would act to increase the cost of servicing debt for households and the cost of capital for business, impacting household consumption and business investment, and hence GDP. Alternatively, banks may pass a portion of the cost onto shareholders (in lower returns) or employees (in lower pay). This could have an impact on GDP should the change in shareholder or employee income lead to a change in their consumption and investment behaviour.

89. As the benefits of ring-fencing are to the economy as a whole, the cost to GDP is the appropriate comparator, and is used for net cost/benefit calculations in this impact assessment.

Cost to public finances

90. In the long run, the level of GDP is the principal determinant of tax receipts. All else equal, a lower level of GDP will therefore result in lower annual tax receipts, representing a cost to the Exchequer. In addition, higher private costs for banks that are partially publicly owned (such as the Royal Bank of Scotland (RBS) and Lloyds Banking Group (LBG)) could also impact on their share prices, and hence the value of Government shareholdings.

Estimated private costs to UK banks

91. The Government estimates that the total private cost of ring-fencing to UK banks will be in the range **£1.8bn-£3.9bn per annum**, with one-off transitional costs in the range **£0.5bn-£3bn**.

92. Private costs have been modelled in four components:

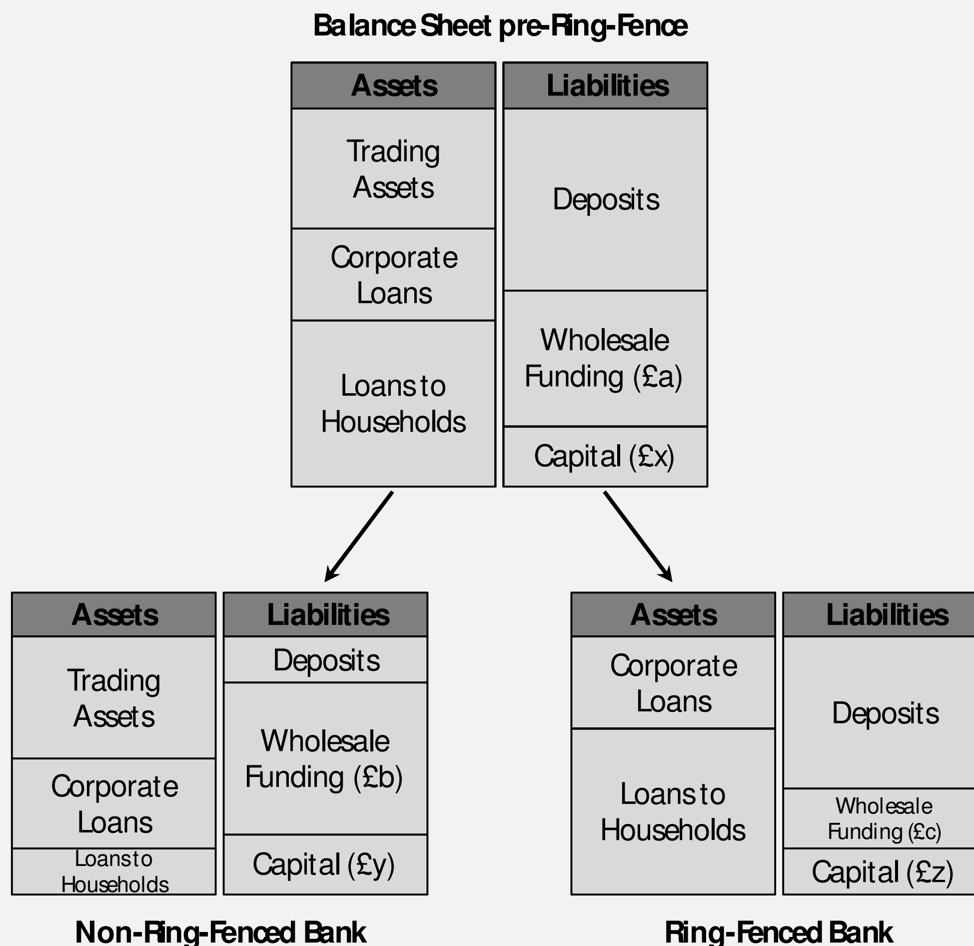
- **Capital costs**: to meet separate capital requirements for ring-fenced and non-ring-fenced banks, banking groups may need to hold more capital in aggregate than in the baseline scenario, generating an ongoing cost.
- **Funding costs**: following ring-fencing, the ongoing cost of wholesale funding for non-ring-fenced banks may rise, as deposits are separated into the ring-fence and if investors perceive non-ring-fenced banks as riskier and more volatile. Conversely, however, the funding cost of ring-fenced banks may fall, if investors see them as better capitalised and less volatile. There may also be a quantity effect on banks' funding requirements as higher levels of capital displace some wholesale debt on the liabilities side of their balance sheets.
- **Operational costs**: banks may incur additional ongoing operating costs from ring-fencing, for example through needing to operate separate administrative systems for ring-fenced and non-ring-fenced entities.
- **Transitional costs**: restructuring in order to meet ring-fencing requirements may involve one-off costs in creating new legal entities and administrative structures, transferring business units etc.

93. The **capital** and **funding costs** of ring-fencing were estimated by drawing on the results of extensive scenario modelling commissioned from the major affected UK banks, simulating the effects of ring-fencing. The banks were asked to model their future balance sheets first under the regulatory conditions set out for the baseline scenario (Option 1), and then in a scenario in which ring-fencing was in force (according to the regulatory assumptions described in paragraph 31 below). To reflect the flexible nature of the ring-fence, banks were left free to decide whether permitted activities (for example household and corporate lending, large corporate deposits) were to be placed in their ring-fenced or non-ring-fenced entities, according to their own preferred commercial strategies.

94. On the basis of this scenario modelling, the Government calculated the aggregate additional capital required by all the affected banks: multiplying this by an assumed range for the cost of capital gave the incremental annual capital cost. The banks' balance sheet scenario modelling also gave the change in the quantity of wholesale funding required by the different banks relative to the baseline. Applying assumptions for the impact of ring-fencing on the cost of funding for ring-fenced and non-ring-fenced banks gave the incremental annual funding cost of ring-fencing. See Box 1 below for further details on how the Government calculated the capital and funding costs.

Box 1: Illustration of method for calculating capital and funding costs of ring-fencing

The Government asked the major affected banks to model their future balance sheets, first under a 'baseline' scenario, and then after a separation into ring-fenced and non-ring-fenced banks. This separation of assets and liabilities can be represented in the schematic diagram below:



(Diagram NOT drawn to scale)

The **incremental capital cost** is calculated in two stages:

Change in quantity = (£y + £z) - £x
Capital cost = (Change in quantity) x (cost of capital)

For assumptions used on cost of capital, see paragraphs 36-37 below.

The **incremental funding cost** can be conceived using the following equations:

(Wholesale (w/s) funding cost) = ((£b x w/s funding $cost_b$*) + (£c x w/s funding* $cost_c$*)) - (£a x funding* $cost_a$*)*

where:

w/s funding costb = w/s funding costa + (non-ring-fenced bank spread)
w/s funding costc = w/s funding costa + (ring-fenced bank spread)

This calculation is applied separately to subordinated, long-term senior unsecured and short-term senior unsecured debt. Details on the assumed changes in prices for each of these types of wholesale funding, for both the ring-fenced and non-ring-fenced banks, are given in paragraphs 38-40 below.

95. Separately, the affected banks were asked to provide estimates of the incremental **operational** and **transitional costs** of ring-fencing. Estimates supplied for the ongoing operational costs were in the range £30m - £105m per bank per year. Estimates for the transitional costs were in the range £100m - £600m per bank. As banks have already begun their preparations for ring-fencing, some of these transitional costs may already have been incurred.

96. The total private costs of ring-fencing, broken down into the four components described above, are summarised in the table below.

Ongoing costs, per year	**LOW**	**HIGH**
Capital	£1.1bn	£2.3bn
Funding	£380m	£1.1bn
Operational	£270m	£570m
TOTAL ONGOING COST, per year	**£1.8bn**	**£3.9bn**
Transitional costs (one-off)	£0.5bn	£3bn

Assumptions, risks and sensitivities: private costs to UK banks

Regulatory assumptions

97. The banks' modelling of their balance sheets under baseline and ring-fencing scenarios described above depended on a series of regulatory assumptions. In the interests of consistency, the Government supplied a set of assumptions for all banks to use as far as possible: these are listed at Annex A below. In some cases, banks were unable to use the prescribed assumptions (for example because banks do not currently collect the relevant data), so had to use their own assumptions or definitions. However, the Government believes that the banks' modelling assumptions broadly reflect the intentions of ring-fencing legislation, and that the effect on modelling results was therefore relatively minor.

Static modelling of balance sheets

98. Modelling of banks' balance sheets for the purposes of this impact assessment was static, i.e. it took no account of potential behavioural responses by either bank customers or management. The only changes to banks' balance sheets were those required to comply with ring-fencing, or to meet perceived market expectations (for example, sufficient capital to ensure a bank could attain the credit rating necessary to operate effectively in the market: this could be above regulatory minima in some cases).

99. In practice, there may be more extensive behavioural responses both from customers (substituting some products for others, or switching between banks) and from banks (adjusting their business lines in response to changed costs and the actions of competitors). These behavioural responses are inherently uncertain and difficult to quantify with confidence. No account has therefore been taken of behavioural responses for the purpose of this impact assessment.

100. Similarly, for the purposes of this impact assessment, modelling has focussed exclusively on the long-run impact of ring-fencing in a 'steady state', i.e. when markets are functioning normally. It is not possible to model with any precision the impact of these measures in a stress scenario, as defining what constitutes a stress scenario, and determining the extent to which such a scenario has an effect on different banks in the market, are subjective and highly

sensitive to assumptions. The impact of these measures in a stress scenario will also likely vary significantly from bank to bank.

101. In theory, curtailing the perceived implicit government guarantee should exaggerate the movement of funds in a stress from banks perceived by market participants as high risk to those perceived as less risky. Such movement could be seen as encouraging more efficient pricing of funds in a stress, and could lower the cost of funds for low-risk banks. At the same time, ring-fencing should make individual banks and the system as a whole more resilient to stress, as a result of higher capital levels and reduced channels of contagion between banks. This should reduce the extent to which funding costs would rise in a stress scenario. There are, however, too many uncertainties involved for meaningful modelling of these different effects, which are therefore excluded from this impact assessment.

Capital cost and availability

102. To calculate the incremental capital cost of ring-fencing, the cost of capital for banks has been assumed to fall in the range 8% - 16% p.a. This range is based around the long-run average cost of capital, 11.5% p.a., used by the Prudential Regulation Authority (PRA).

103. For the purposes of this impact assessment, it has also been assumed that the additional capital required to comply with ring-fencing requirements is available to UK banks. The Government estimates that the total amount of additional capital (relative to the baseline) required by UK banks is approximately £14.25bn. Banks have a range of options for increasing their capital levels, including raising capital externally and generating equity internally through retained earnings. With several years until the final deadline for compliance, the Government is confident that banks will be able to raise the additional capital required.

Wholesale funding costs

104. The impact of ring-fencing on banks' funding costs is difficult to forecast precisely. The reduction in the perceived implicit government guarantee should result in a general increase in the price banks are required to pay for wholesale funding. Among banks, it is likely that funding costs for ring-fenced banks will fall, while costs for non-ring-fenced banks will rise, reflecting differences in their revenue volatility. Both ring-fenced and non-ring-fenced banks may see funding costs increase as a result of reduced revenue diversification. Increases in the cost of funding may, however, be offset by reductions in the quantities of wholesale funding that banks require, for example as a result of increased capital levels.

105. For their modelling of the impact of ring-fencing, the banks typically assumed that the price of debt issued by ring-fenced banks would remain the same as in the baseline scenario, and used a range of assumptions for the change in the price of different classes of debt issued by non-ring-fenced banks. The Government drew on these to produce high and low assumptions for the impact on banks' overall costs of wholesale debts: these are summarised in the table below. The Government then applied the highest and lowest of these assumptions to each bank to estimate the aggregate incremental funding cost.

Class of funding	LOW	HIGH
Subordinated debt	+75bps	+150bps
Long-term senior unsecured debt	+25bps	+100bps

106. It is important to note that these estimated funding costs do not include the impact of bail-in, which is outside the scope of this impact assessment.

Estimated social cost to UK economy

107. The Government expects that, all else equal and relative to the 'do nothing' baseline, ring-fencing will result in a gross **reduction in the long-run level of GDP in the range 0.04%-0.18%**. This is equivalent to an average annual cost to GDP of £0.4bn-£2.2bn.

108. The GDP impact of ring-fencing was modelled by the PRA on the basis of banks' estimates of the private costs of ring-fencing, using the NiGEM model. NiGEM is an empirically-based econometric model that can estimate the impact on economic output of changes to banks' minimum capital ratios, funding and operational costs. The model uses long-run historical data that capture the various channels (e.g. changes in the consumption behaviour of economic agents such as bank customers or shareholders) through which changes to bank private costs feed through to the wider economy.

109. Note that the cost to GDP (social cost) is expected to be lower than the (private) cost to banks: this reflects the fact that much of the private cost to banks arises from the withdrawal of the implicit subsidy represented by the perceived implicit government guarantee. The removal of this subsidy transfers costs *within* the economy (from government to banks): it is not a cost to GDP overall.[3]

Assumptions, risks and sensitivities: social cost to UK economy

NiGEM modelling of long-run GDP cost

110. The NiGEM model calculates the cost to GDP on the basis that banks pass on to consumers near to 100% of the additional private costs. This suggests that little, if any, private cost will directly transmit to banks' profits.[4] The Government recognises that using historical evidence may not truly reflect future trends, and so the pass through in the future may not be the same. Also, how banks pass on any increase in their private costs is a commercial decision and so cannot be forecast with certainty.

111. The key inputs to the NiGEM model are the changes in banks' capital ratios and incremental funding, operational and transitional costs. NiGEM models the impact of changes to these variables on a forecast GDP path: for these purposes, the following assumptions were made about the timescales over which the different private costs to banks were incurred:

- **capital ratios** increase steadily year on year until reaching the point at which banks hold sufficient capital to meet the policy requirements by the deadline for compliance in 2019. From this point, the capital costs are constant each year.
- **funding costs** increase steadily year on year over the transition period until 2019, after which they are constant year on year.
- **operational costs** ongoing costs are zero in the first two years, but are then constant each year thereafter.
- **transitional costs** are incurred in the first two years of the transition period of the policy only.

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[3] Indeed, subsidy removal is expected to increase overall economic efficiency and thus GDP in the long run: see paragraphs 55-63 below for a discussion of the expected benefits of ring-fencing.

[4] Though there could be a second-round impact on banks' profits to the extent that higher prices reduce demand for banking services.

Calculating the present value of the GDP cost

112. Ring-fencing is intended as a permanent reform to the UK banking sector. For the purposes of calculating the present value of GDP costs for this impact assessment, the annual costs (and benefits) to GDP have been assumed to persist for 30 years, discounted according to HM Treasury Green Book guidance. The Government recognises that the present value costs and benefits of the policy will extend (albeit at diminishing levels) beyond the 30-year policy period chosen.

Short-run GDP impact

113. In the long run, by making UK banks more resilient and resolvable and thus curtailing the perceived implicit government guarantee, ring-fencing is expected to support a more efficient supply of credit to the economy. There is a risk that in the short-term however, banks could respond to the new regulations, in particular higher capital requirements, by shrinking their balance sheets and cutting back lending to the real economy to meet the capital requirements. External estimates suggest that there can be a cost to GDP when banks are required to increase capital requirements in a short period of time.[5]

114. In line with the ICB's recommendations, the Government has established 2019 as the final deadline for compliance with ring-fencing. This gives UK banks several years in which to raise the additional capital required (as well as to implement the necessary restructuring). As noted in paragraph 37 above, UK banks will have a range of options for raising additional capital. The Government therefore believes that the extended timetable for compliance proposed by the ICB will mitigate the risks of banks deleveraging significantly in the short term in response to the new regulations.

Estimated cost to public finances

115. Ring-fencing is estimated to produce a gross **reduction in tax receipts of £150m-£750m per year** and a **reduction in the value of the Government's shareholdings in partially publicly-owned banks of £0.9bn-£3.5bn**, relative to the 'do nothing' baseline.

116. The main driver of the estimated **reduction in tax receipts** is the impact on GDP. In the long run, the principal determinant of the level of annual tax receipts is GDP: all else equal, lower GDP would therefore result in lower tax receipts for the Exchequer. Having estimated the impact on GDP of the measures in the Bill as described above, the Government estimated the impact on tax receipts by applying the long-run average tax:GDP ratio (35.2 per cent). This gives a reduction in tax receipts of £150m-£750m per year.

117. The estimated **reduction in the value of Government shareholdings** is the result of increased private costs for partially publicly-owned banks such as the Royal Bank of Scotland (RBS) and Lloyds Banking Group (LBG). To the extent that proceeding with ring-fencing reduces the eventual proceeds from selling the Government's shareholdings, there will be an additional cost to the public finances, which will crystallise when the shareholdings are sold. However, with markets already anticipating the implementation of ring-fencing, it is likely that the impact is already largely or entirely factored into the two banks' current market share prices.

118. On the basis of the impact modelling supplied by the two banks, UK Financial Investments Ltd (UKFI) applied standard bank valuation methods to estimate the potential loss to the value of the Government's shareholding in RBS and LBG from proceeding with ring-

[5] For example, *Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements*, Basel Committee on Banking Supervision, December 2010.

fencing. These estimates are not of the value impact relative to today's prices: rather, they compare the projected value of the Government shareholdings with a counterfactual future scenario in which the ring-fence is not implemented. Key inputs to this modelling are the impact on the banks' return on equity (based on the banks' own modelling and estimates of changes to their funding and operating costs) and the assumed cost of equity.

119. As with the other cost estimates for this impact assessment, no account was taken of behavioural responses by bank customers or management. Unlike other cost estimates, however, UKFI's value estimates do not assume any pass-through of banks' higher private costs to customers. As the impact on banks' profits, and hence share prices, may be mitigated to the extent that they can pass higher costs on to their customers, this may lead to some double-counting of costs. Given these caveats, the UKFI estimates should be viewed as broadly indicative of the maximum extent of shareholder costs, rather than precise forecasts.

120. Applying these assumptions and methods gives an estimated reduction in the value of Government shareholdings in the range £0.9bn-£3.5bn. This is somewhat lower than in previous impact assessments on the Government's banking reform measures. To some extent this is the result of recent reductions in the Government's stake in LBG. It may also reflect changes in the banks' strategies, for example the revised RBS strategy with its increased focus on core UK retail and commercial business that was announced in February 2014. To the extent that such changes have been driven primarily by anticipation of the Government's banking reform measures, some of the value impact may have been already crystallised in the banks' baseline projections. Where changes in business strategy have been driven by other factors, however, the response to these other factors will have mitigated the impact of banking reform, including ring-fencing.

Benefits of Option 2: Proceed with ring-fencing

121. Ring-fencing aims to promote greater financial stability in the UK, by curtailing the perceived implicit government guarantee to banks. Curtailing the perceived implicit guarantee will reduce banks' incentives to take on excessive risks, tackling the moral hazard that the perception of a guarantee creates. Curtailing the perceived implicit guarantee should bring a benefit to the Government's borrowing costs, as sovereign debt investors perceive a reduction in the Government's contingent liability to the banking sector (that is, a reduced likelihood of the Government needing to use public funds to support failing banks in a future financial crisis).

122. Ring-fencing will also make banks more resilient to shocks (reducing the likelihood of bank failure) and more easily resolvable in the event of failure (reducing the impact on the economy and the public finances of bank failure). This should therefore make banking crises less frequent and less costly to the economy in the future, resulting in a higher level of GDP in the long run (and as a consequence, all else equal, higher tax receipts). Independent of the level of GDP, there is likely to be a welfare benefit from a more stable path for GDP, as individuals and firms value stability of income as well as income levels. Greater stability of GDP could also increase confidence in the economy and provide a better environment for investment.

Challenges in quantifying economic benefits of greater financial stability

123. As the experience of the 2007-09 financial crisis showed, the costs of financial instability can be very substantial. According to the Office for National Statistics (ONS), the crisis led to a peak-to-trough fall in GDP of 7.2%, while the Office for Budget Responsibility (OBR) estimated that potential output in the last quarter of 2013 was around 12% below its pre-crisis trend.[6] During the crisis, as GDP, and with it tax receipts, fell sharply, public spending (based on the plans set out in the 2007 Comprehensive Spending Review) increased rapidly as a share of GDP, which caused a sharp deterioration in the public finances. In addition, the public finances faced the very substantial costs of direct support to the UK financial system, which at peak amounted to over £120bn in cash support and a further £1tn in guarantees and contingent liabilities.[7] Academic estimates of the costs of financial stability are similarly large: on the basis of a survey of academic research compiled by the Basel Committee on Banking Supervision (BCBS), the ICB estimated that the annual cost to the UK of financial crises was approximately 3% of GDP, or around £40bn in 2010 terms.[8]

124. The economic benefits of preventing or ameliorating future financial crises will therefore be similarly large. Quantifying those benefits is very challenging, however, as it cannot be known how often financial crises will occur in the future (either following the implementation of financial sector reforms, or in the baseline counterfactual): nor can future crises' form and severity be forecast with certainty.

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[6] *Quarterly National Accounts, Q1 2013*, Office for National Statistics, June 2013. *Economic and Fiscal Outlook*, Office for Budget Responsibility, March 2014.

[7] *The Comptroller and Auditor General's Report on Accounts to the House of Commons: The Financial Stability Interventions*, National Audit Office, July 2011.

[8] *Final Report: Recommendations*, Independent Commission on Banking, September 2011, paragraphs 5.8 and 5.67. The survey of academic estimates was published in *An Assessment of the Long-term Economic Impact of Stronger Capital and Liquidity Requirements*, Basel Committee on Banking Supervision, 2010. From the literature surveyed by the BCBS, the ICB drew average values for the probability of crises in a given year (4.5%) and the net present value output cost of a crisis occurring (63%). Multiplying these gives an annual cost of 2.84% of GDP.

Illustrative calculations of benefits of increased financial stability

125. It is, however, possible to give a sense of the scale of the benefits of greater financial stability by means of illustrative calculations. A starting point could be the ICB's average figures for the likelihood of financial crises (4.5% probability of a crisis occurring in a given year) and severity of a financial crisis (63% reduction in GDP), giving an annual cost of financial crises of 2.8% of GDP (around £40bn p.a. in 2010 terms, £45.8bn in 2013 terms).

126. If ring-fencing, along with higher capital requirements and improved prudential regulation and supervision reduced the likelihood of crises by 40% (to 2.7%), then all else equal, this would reduce the average annual cost of financial crises to 1.7% of GDP (£27.4bn in 2013 terms). If in addition to this reduction in the likelihood of crises, ring-fencing and the introduction of resolution powers reduced the severity of future financial crises by 40% (to 38%), this would reduce the average annual cost of financial crises to 1.02% of GDP (£16.5bn in 2013 terms). In this scenario, financial sector reforms would have generated a benefit to the UK economy of 1.81% of GDP (equivalent to £29.3bn in 2013 terms) per annum.

127. The changes to the probability and severity of future financial crises illustrated here would be the result of the full set of financial sector reforms introduced since the last financial crisis, so the benefits could not all be attributed to ring-fencing. As ring-fencing is complementary to wider reforms, isolating its specific impact as distinct from those of other reforms is very challenging. If it is assumed that ring-fencing accounts for 25% of the total effect of financial sector reform, then ring-fencing would yield an economic benefit of 0.54% of GDP (equivalent to £8.8bn in 2013 terms) per annum. This is significantly greater than the high-end estimate of the GDP cost of ring-fencing (see paragraph 41 above). In reality, ring-fencing may account for a greater share of the total benefits of financial sector reform.

Sensitivity analysis

128. Illustrative calculations of this sort are naturally sensitive to the inputs and assumptions used. The key inputs are the estimated likelihood and severity of financial crises: as the ICB noted, the range of academic estimates for these figures is very wide (with the estimated likelihood of a crisis in a given year ranging from 3.6% to 5.2%, and the estimated severity of a crisis ranging from 16% to 302% of GDP). These give a range for the annual cost of crises from 0.58% to 15.7% of GDP (£9bn to £253bn in 2013 terms).

129. If the lowest academic estimates for these two variables are used in the illustrative calculation presented above, then reducing the likelihood and severity of future crises by 40% each would yield a benefit to the economy of 0.37% of GDP (equivalent to £5.9 in 2013 terms). In this scenario, in order to yield benefits greater than the estimated GDP cost, ring-fencing would need to account for just under 50% of the benefits of financial sector reform. Alternatively, if the highest academic estimates for likelihood and severity are used, then a reduction of 40% in each would yield an economic benefit of 10% of GDP (£162bn in 2013 terms) per year. In this scenario, ring-fencing would only need to account for 1.8% of the total impact of financial sector for the economic benefits of ring-fencing to exceed the economic costs.

Conclusion on costs and benefits

130. Ring-fencing will increase the resilience and resolvability of UK banks, and will thus reduce both the likelihood and the severity of future financial crises. Although the costs of future financial crises cannot be forecast with certainty, given that financial crises are known to be very costly, and that only relatively modest improvements in UK financial stability are needed in order to yield very substantial economic benefits, **the Government concludes that the benefits of ring-fence outweigh the costs**. The Government is therefore proceeding with ring-fencing, by making ring-fencing secondary legislation.

Rationale for the level of analysis in this impact assessment

Proportionality

131. Ring-fencing is the product of extensive policy development and consultation by both the ICB and the Government over a period of around 4 years. During this period, a wide range of alternative approaches have been considered, including alternative models for structural reform of banks (e.g. full separation of retail and investment banking, full reserve banking and narrow banking considered by the ICB) and different options for the calibration of the ring-fence (e.g. alternative calibrations considered for the Government's Banking Reform White Paper).

132. With these alternatives having been discarded at earlier stages, analysis for this impact assessment has focussed exclusively on the impact of the measures included in the ring-fencing secondary legislation, which have been compared to a 'Do Nothing' alternative.

Wider impacts

133. There are a number of wider impacts that have been considered. These are detailed below.

Impact on competition in the UK banking sector

134. Reducing the perceived implicit government guarantee for large UK banks that are seen as 'too big to fail' should support competition in the UK banking sector, as the perceived implicit guarantee gives a competitive advantage to large banks over smaller competitors, who are not seen as benefiting from an implicit guarantee. Reducing the perceived implicit guarantee will thus reduce the competitive disadvantage for smaller banks and should support greater competition in the market.

Distribution of the impact in the market

135. The aggregate private costs to the banking industry are £1.8bn- £3.9bn. The cost to each bank in the industry as a result of the policy option will be different, as they have different business models. There is, however, some flexibility in how banks can adjust their businesses to the requirements of ring-fencing, which gives them scope to find an optimal business model. It is not possible to disaggregate the impact for each of the UK banks affected, as this is commercially sensitive data.

Impact on the labour market

136. Imposing additional costs on UK banks could have consequences for the labour market, to the extent that banks choose to pass higher costs on to their employees by reducing overall remuneration levels. However, it is not clear whether, or to what extent, banks will in fact pass costs on to employees: this would be a commercial decision for each bank, which it is not possible for the Government to forecast with any certainty.

Business borrowing distortions

137. An increase in banks' private costs may lead to an increase in lending rates. Larger businesses that are not reliant upon funding through these banks, and can access funds from alternative sources, would be less affected by the increase in bank lending costs than smaller businesses that may be more dependent on funding from banks. Whether and how banks choose to pass on additional costs to their customers is a commercial decision for each bank, which it is not possible for the Government to forecast with any certainty.

Impact on competitiveness of UK banking sector

138. The Government believes that ring-fencing will enhance competitiveness in the UK financial sector in the long run, through greater financial and macroeconomic stability. It is imperative that such regulatory reform is introduced to make the UK banking sector more stable and intervention at the taxpayers' expense less likely in future.

Expected finance and resource impact on other Departments

139. Enforcing and policing the ring fence will incur costs to the PRA. The FSA estimated that the upfront cost to the regulator of implementing the ICB's recommendations (including ring-fencing) was no more than £20m, with subsequent ongoing costs of around £2m per annum. The costs of enforcing just ring-fencing will likely be somewhat lower.

Equality impact

140. The Government has considered its obligations under the Equalities Act 2010. The Government does not believe these measures will impact upon discrimination, equality of opportunity or good relations towards people who share relevant protected characteristics under that Act.

141. The Government considers that the proposals are compatible with the Convention rights protected under the Human Rights Act 1998.

Summary and implementation plan

Chosen policy option

142. The Government therefore proposes to implement ring-fencing (Option 2). The Government believes that implementing these measures will deliver net benefits relative to the baseline (Option 1).

Implementation plan and post-implementation review

143. The Government is now making ring-fencing secondary legislation, setting the precise details of the calibration of the ring-fence. The deadline for banks to comply with ring-fencing is 2019. Under the Financial Services (Banking Reform) Act 2013, there will be an independent review of the operation of ring-fencing legislation within two years of the ring-fence coming into force, (i.e. by 2021).

Annex A: Regulatory assumptions for bank modelling

144. Listed below are the assumptions the Government asked banks to use in modelling their balance sheets in both the 'do nothing' baseline scenario, and in the ring-fencing scenario. 'RFB' means ring-fenced bank.

'Do nothing' baseline scenario

Parameter	Assumption
Capital requirements	Basel III minimum requirements: • Min Common Equity Tier 1 (CET1) ratio: 7% RWAs (=4.5% 'hard' minimum plus 2.5% Capital Conservation Buffer); • Min Tier1 ratio: 8.5% RWAs; • Min Total Capital ratio: 10.5% RWAs. G-SIB surcharge: • Min CET1 ratio increased by 2.5% RWAs. 'Management buffer': • Min CET1 ratio increased by 1% RWAs. Leverage ratio • Min Tier 1 Capital to Total Exposures: 3%. Basel III capital definitions fully in force.
Liquidity requirements	Existing PRA liquidity regulations.
'PLAC' requirements	None.
Ring-fencing requirements	None.

Ring-fencing scenario

Parameter	Assumption
Capital requirements	Basel III minimum requirements (as in baseline scenario) ***plus*** 'Ring-fence buffer': • Min CET1 ratio increased by 3% RWAs for RFBs.
Liquidity requirements	Existing PRA liquidity regulations.
'PLAC' requirements	Minimum 'PLAC' (=regulatory capital plus best-quality loss-absorbing debt) ratio of 19% RWAs (17% RWAs regulatory minimum, plus 2% RWAs management buffer). Total PLAC requirement applies at Group level for UK G-SIBs, but with exemption for overseas RWAs where overseas operations do not threaten EEA financial stability.
Ring-fencing requirements	
De minimis exemption from ring-fencing	Banks with core deposits of less than £25bn exempt from ring-fencing.
Core ('mandated') Services	Accepting deposits (except from non-SME organisations and high-net-worth individual private banking customers) is the only core activity (i.e. may only be carried out by Ring-fenced banks (RFBs) or banks exempt from ring-fencing).
Definition of SME	Banks made own assumptions.
Definition of private banking customer	Banks made own assumptions.
Excluded ('prohibited') Services	RFBs prohibited from dealing in investments as principal, entering into derivatives contracts, or underwriting securities issues. RFBs prohibited from non-EEA business and transacting with financial institutions, other than for risk management and payments purposes.
Permitted Services	Permitted services are those that are not 'core' or 'excluded' as defined by ring-fencing legislation, and may be undertaken by either ring-fenced or non-ring-fenced banks. RFBs may deal in investments as principal and enter into derivative contracts for the purposes of hedging risks arising from banking activities and/or for purposes of liquidity management. RFBs permitted to offer simple risk-management products to customers, subject to safeguards.
Geographical scope of ring-fence	Booking location of transactions used as proxy for ban on RFBs establishing non-EEA branches/subsidiaries: no assets/liabilities booked outside EEA permitted in RFBs.
Status of Crown Dependencies	Crown Dependencies (Jersey, Guernsey, Isle of Man) treated as within EEA for purposes of ring-fence geographical scope.
Restrictions on RFB exposures to financial institutions	RFBs prohibited from providing services to any financial institutions except those that are SMEs.
Intra-group exposure limits	Exposures between RFB and rest of group subject to standard large exposure limits i.e. may not exceed 25% of regulatory capital.
Wholesale funding limit for RFBs	No more than 50% of RFB funding can be wholesale.