Summary: Intervention & Options

Department /Agency:	Title:	
HM Treasury	**Impact Assessment of The Scottish and Northern Ireland Banknote Regulations 2009**	
Stage: Implementation stage	**Version:** Final	**Date:** 12 October 2009

Related Publications: Banknote issue arrangements in Scotland and Northern Ireland (July 2005), Financial stability and depositor protection (Jan and July 2008), The Scottish and Northern Ireland Banknote Regulations 2009: a consultation on secondary legislation (June 2009)

Available to view or download at:

http://www.hm-treasury.gov.uk/consult_fullindex.htm

Contact for enquiries: sarah.gannaway@hm-treasury.gov.uk **Telephone:** 020 7270 6273

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

Longstanding primary legislation regulating commercial banknote issuance in Scotland and Northern Ireland does not provide sufficient protection for the holders of such banknotes should an issuing bank fail. Part 6 of the Banking Act 2009, and the secondary legislation considered here, are seeking to modernise the arrangements underpinning commercial banknote issuance in Scotland and Northern Ireland. The overall aim is to ensure that holders of Scottish and Northern Ireland banknotes have a level of protection similar to that of holders of Bank of England notes, and, in the event of an issuing bank failing, can expect to obtain full face value for their notes.

What are the policy objectives and the intended effects?

The overall aim is to ensure that holders of Scottish and Northern Ireland banknotes have a level of protection similar to that of holders of Bank of England notes. The framework is set out in the Banking Act 2009 while the detail is to be captured in the banknote regulations and rules. These regulations cover a variety of provisions but the principal objectives are to ensure noteholder protection through the holding of sufficient backing assets at all times, and to ring-fence those backing assets in the event of insolvency. Accompanying powers are given to the Bank of England (the Bank), including a power to monitor compliance and impose sanctions if necessary. The intended effect will be to strengthen underlying confidence in these notes as noteholders will have more robust protection.

What policy options have been considered? Please justify any preferred option.

These regulations form part of the legislative framework to be enacted under Part 6 of the Banking Act 2009. The Government has previously consulted on these arrangements (see related publications above). In doing so it considered alternative policy options, such as maintaining the status quo and securing a voluntary agreement between note issuers. Alternative options were discounted in the process of consultation and these regulations reflect the preferred option. A legislative option provides more robust protection for noteholders if a note issuing bank were to fail.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects? Government will work closely with the Bank of England and the note issuing banks to ensure that the legislation achieves its intended effect. The Bank will publish an annual report on the performance of the new arrangements.

Ministerial Sign-off For Implementation Stage Impact Assessments:

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) the benefits justify the costs.

Signed by the responsible Minister: Date: 10 October 2009

Sarah McCarthy-Fry

Summary: Analysis & Evidence

Policy Option:	Description:

COSTS

ANNUAL COSTS		
One-off (Transition)	**Yrs**	
£ 0.6m (approx)	1	
Average Annual Cost (excluding one-off)		
£ 0.6m (approx)		

Description and scale of **key monetised costs** by 'main affected groups' These arrangements affect the 7 issuing banks, and the Bank of England as regulator. The main costs arise from stronger reporting requirements for the note issuers and the regulatory costs of the Bank to check compliance.

Total Cost (PV) **£ 5.59m approx**

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

BENEFITS

ANNUAL BENEFITS		
One-off	**Yrs**	
£ 0		
Average Annual Benefit (excluding one-off)		
£ 0.001m		

Description and scale of **key monetised benefits** by 'main affected groups' These proposals are estimated to be revenue neutral in terms of seigniorage income for the Exchequer. There are small administrative benefits to HMRC as it will cease a minor reporting function.

Total Benefit (PV) **£ 0.009m approx**

Other **key non-monetised benefits** by 'main affected groups' The main benefit is the improved level of protection that holders of Scottish and Northern Ireland banknotes will have in the event of an issuing bank failing and, if it should happen, that they can expect to obtain full face value for their notes. This improved protection also supports overall confidence in UK currency.

Key Assumptions/Sensitivities/Risks These arrangements will be ongoing but a 10 year timeframe has been assumed for the cost/benefit calculation. The discount rate used is 3.5%. It is not possible to quantify the benefits associated with improved noteholder protection or the improved confidence in UK currency. However, while considered unlikely, the economic costs of a loss of confidence in the currency would likely far outweigh the costs quoted above.

Price Base Year 2009	Time Period Years 10	**Net Benefit Range** (NPV) £	**NET BENEFIT** (NPV Best estimate) **£ -5.58m approx**

What is the geographic coverage of the policy/option?			UK (mainly S&NI)	
On what date will the policy be implemented?			November 2009	
Which organisation(s) will enforce the policy?			Bank of England	
What is the total annual cost of enforcement for these organisations?			£ 0.5m approx	
Does enforcement comply with Hampton principles?			Yes	
Will implementation go beyond minimum EU requirements?			N/A	
What is the value of the proposed offsetting measure per year?			£ N/A	
What is the value of changes in greenhouse gas emissions?			£ N/A	
Will the proposal have a significant impact on competition?			No	
Annual cost (£-£) per organisation (excluding one-off)	Micro	Small	Medium	Large
Are any of these organisations exempt?	No	No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices) (Increase - Decrease)

Increase of £ Decrease of £ **Net Impact** **£**

Key: **Annual costs and benefits: Constant Prices** **(Net) Present Value**

Evidence Base (for summary sheets)

Introduction

Banknote issuance is normally a monopoly of the central bank, which in the United Kingdom is the Bank of England. However, 7 commercial banks have retained the right to issue their own banknotes in Scotland and Northern Ireland.

In Scotland, they are: Bank of Scotland; Clydesdale Bank; and the Royal Bank of Scotland. In Northern Ireland, they are: Bank of Ireland; First Trust Bank; Northern Bank; and Ulster Bank.

There are currently approximately £3.2 billion Scottish notes and £1.7 billion Northern Ireland notes in circulation. By comparison, there are approximately £46 billion Bank of England banknotes in circulation.

The Government is committed to maintaining the long-standing tradition of commercial banknote issuance in Scotland and Northern Ireland, and is not seeking to discourage these commercial issuers of banknotes from continuing with this practice.

The Government stands behind all banknotes issued by the Bank of England. Banknotes issued by commercial banks in Scotland and Northern Ireland are a liability of each of those banks. This has always been the case.

The Government understands that, under the existing legislation, a number of issuing banks are substituting some or all of the Bank of England banknotes that they hold as backing assets over the weekend for other assets during the week.

Moreover, the precise purpose of these note-covering assets is not set out in the current legislation. In the event of an issuing bank becoming insolvent, there is no provision requiring the backing assets to be ring-fenced for noteholders in order that they can be given value for their notes from the note covering assets in priority over all other creditors. As the notes themselves do not confer preferred creditor status, note holders may not, therefore, receive full value for the notes they hold, should an issuer encounter financial difficulties.

The Banking Act 2009 therefore contains provisions that strengthen and modernise arrangements underpinning commercial banknote issuance that date back almost 160 years.

The Government's aim is to ensure that holders of Scottish and Northern Ireland banknotes have a level of protection similar to that of holders of Bank of England notes, and, in the event of an issuing bank failing, can expect to obtain full face value for their notes. This is an important part of the Government's commitment to protecting consumers.

Affected groups

The new legislation will affect the 7 commercial banks that issue banknotes in Scotland and Northern Ireland. The position of holders of Scottish and Northern Ireland banknotes, as creditors, will be affected on the insolvency of a note issuing bank. The transfer of regulatory responsibility will affect HMRC and the Bank of England.

Banknote rules

The framework governing the issue of Scottish and Northern Ireland banknotes is set out in primary legislation, while the detail of the provisions of Part 6 is to be captured in the banknote regulations and banknote rules.

This is because it is necessary to provide the authorities with the appropriate flexibility to make detailed provision as appropriate, depending on criteria such as Parliamentary scrutiny and the ability to make changes quickly.

Banknote rules may only make provision as specified in the banknote regulations. It is important for the Bank of England to have the freedom – within the remit of the Parliament-approved regulations – to make and modify detailed banknote rules in order to adapt to changing or particular circumstances and to capture operational detail.

Backing assets

One of the main changes encapsulated within the new framework is the need for issuing banks to hold backing assets at all times equal to the value of their notes in circulation and their notes with the potential to enter circulation.

As set out in regulation 6(5), backing assets representing at least 60% of the notes in circulation must consist of Bank of England banknotes and current coins of the United Kingdom. Notes with the potential to enter circulation and the balance of notes in circulation that are not backed by Bank of England banknotes or current UK coin may be backed by funds held in a designated interest-bearing account.

The net result of the new backing asset requirements – across all 7 issuing banks – is estimated to be revenue neutral in terms of seigniorage income to the Exchequer.

Approved and designated locations

Some consultation responses noted that in order to meet the required specifications, significant costs may be incurred to improve locations intended to be used for the holding of backing assets, and for the holding of excluded notes. The Treasury notes the potential for these costs but they cannot currently be quantified, as the full details of any such locations are not yet known, the Bank of England has not completed its full assessment of them, and more importantly, the conditions governing the required specifications have not yet been finalised.

Information

In order to ensure compliance with the new regime, the regulations permit the rules to make provisions about reports that the issuing banks must submit to the Bank of England. The reporting software will be run across a web-interface and therefore no new software will be required by the authorised banks for the purposes of reporting the required information. It is estimated that there may be a one-off cost to update the issuing banks' systems so that they are able to provide the required information, although this will vary by bank.

The reporting requirements replace the equivalent obligation that exists under the current legislation for issuing banks to report to HMRC on their notes in circulation, and their backing assets held at the Bank of England and in approved locations.

Some additional information (such as that pertaining to excluded banknotes, printing and destruction of notes) will be required, and it is currently proposed that issuing banks will be required to provide weekly estimates of their peak notes in circulation, as well as actual daily figures retrospectively. However it is estimated that these requirements should not present an undue cost or administrative burden on the issuing banks. These reports are necessary for the Bank of England to confirm that sufficient levels of backing assets are being held at all times, and therefore ensure noteholder protection.

The Bank of England may also require an issuing bank to provide a report by an independent auditor or skilled person about those reports that the issuing bank submits under regulation 14. The costs of doing so are to be borne by the issuing bank.

Insolvency

In the event of an issuing bank entering an insolvency process, the Bank of England will commence a note exchange programme whereby holders of the bank's notes would be able to exchange them for value. The costs for a note-exchange programme are not expected to be significant but cannot be accurately quantified as there is no exact precedent for such arrangements. The Bank of England will produce an annual report on the discharge of its functions under Part 6 of the Banking Act 2009, where it may provide details on any expenses (or receipts) incurred.

Ceasing issue

If an issuing bank stops issuing banknotes voluntarily (or the Treasury terminates its right to issue) then the banknote rules may specify a procedure to be followed to ensure its notes are withdrawn from circulation. Any costs of administering this exchange are to be borne by the issuing bank. This is not expected to carry any additional costs over that which could be expected under the current regime.

Some consultation responses noted that non-affected banks might incur additional costs as a result of another authorised bank ceasing to issue banknotes (either voluntarily, by termination by the Treasury, or by entering an insolvency process). Such costs might arise by the non-affected banks' increased market share of note issue in either Scotland or Northern Ireland (and therefore additional backing asset requirements), or through additional processing costs incurred by helping to facilitate a Note Exchange Programme. Any such costs would depend on the particular circumstances of the individual case, and only if an authorised bank were to cease its note issue.

Benefits

There will be a negligible administrative saving to HMRC of an estimated £1000 per year. This is based on the assumption that the limited regulatory role that HMRC currently has (whereby it checks the data is supplied by the issuing banks, and that the reported figures for backing assets equal or exceed those for notes in circulation) currently amounts to approximately an hour's clerical work a week.

The principal benefit of the new framework is enhanced protection for holders of Scottish and Northern Ireland banknotes, to ensure that the £4.9 billion commercially issued banknotes in circulation in Scotland and Northern Ireland could be exchanged for value in the event of an issuing bank entering an insolvency process. This benefit could in theory be quantified by comparing the dividend that a noteholder might receive as an unsecured creditor in an insolvency process under the current regime with what they would be expected to receive from a note exchange programme under the new framework.

Under the current legislation, if an issuing bank were to enter an insolvency process, then noteholders would become ordinary unsecured creditors in that process. As set out above, the current legislation does not make provision to ring-fence backing assets for the benefit of noteholders, and some of the backing assets held are substituted for other assets during the week. Therefore under the existing legislation, noteholders could receive less than face value for their notes in an insolvency process. In practice, the return to an unsecured creditor in an insolvency process will vary, depending on the circumstances. It is therefore impossible to put a precise figure on the expected divided, or on the exact value of the benefit afforded to noteholders by the new regime.

If this unlikely event were to occur, confidence in UK banknotes may be impacted more widely. It is not possible to quantify the cost of a broader loss of confidence.

Costs

The Bank of England estimates that it will incur £500,000 one-off set-up costs, which covers the cost of development and implementation of the reporting and compliance systems for the new regime (estimate includes additional staff resource, software development and testing). The Bank of England estimates the annual costs of carrying out its role as regulator to be £500,000 per year. This includes staff costs for monitoring compliance by the issuing banks and system maintenance, including licences.

The Bank of England will undertake a regulatory role, rather than the administrative function currently undertaken by HMRC. Not only will they be checking daily data entries across more fields, but the Bank of England will also be monitoring this data more regularly, and will also take action to corroborate such data, for example, by compliance visits to approved locations and checking of security provisions and that the backing assets are appropriately segregated and labelled.

It is estimated that the 7 issuing banks will have an initial set-up cost to get their systems to a point where they are able to provide the required information. However, this will vary by bank due to the differences in their existing systems. For some, the system requirements will be similar to that they already use for the Bank of England's Note Circulation Scheme (NCS). It is estimated that overall, the total one-off costs (for all 7 issuing banks) will be approximately £100,000.

Across all 7 banks, it is estimated that the new reporting requirements will have a cost of approximately £100,000 per year. This is based on an assumption that there will be an increased burden of approximately 2 hours per day to collate and report the required data, and for changes to storage requirements for excluded notes and backing assets (separation, labelling, Bank of England compliance visits etc). This additional time will be incurred by a mixture of staff at different levels: cash centre workers, data entry, financial officers and managers. It is anticipated that there will also be some additional overhead costs (i.e. overtime, benefits, desk space, PC, contingency/DR plans, site/system maintenance, additional security provisions and so on), resulting in the overall estimate of £100,000 per year for all 7 issuing banks.

Competition

During two rounds of public consultation, no non-issuing banks raised concerns about there being an uneven playing field because no new issuers are permitted.

However, some respondents felt that insufficient account had been taken of the costs associated with issuing banknotes and the social benefits supported by the income derived.

Government has since worked closely with the industry to better understand the relative costs and benefits of commercial banknote issuance.

This has resulted in a new framework that improves consumer protection for noteholders while supporting the continuation of the long-standing tradition in Scotland and Northern Ireland of banknote issuance.

This new framework was consulted on in the July 2008 document "Financial stability and depositor protection: further consultation", when responses indicated that it is broadly supported.

Risks

Should an issuing bank stop issuing its own banknotes, there could be an additional cost to the Bank of England from increasing its distribution of banknotes. This assumes the bank concerned does not seek to dispense the notes of another commercial issuing bank.

Specific Impact Tests: Checklist

Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.

Type of testing undertaken	***Results in Evidence Base?***	***Results annexed?***
Competition Assessment	Yes	No
Small Firms Impact Test	No	No
Legal Aid	No	No
Sustainable Development	No	No
Carbon Assessment	No	No
Other Environment	No	No
Health Impact Assessment	No	No
Race Equality	No	No
Disability Equality	No	No
Gender Equality	No	No
Human Rights	No	No
Rural Proofing	No	No