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|---|---|
| **Title:**<br>**A new approach to financial regulation**<br>**Lead department or agency:**<br>HM Treasury<br>**Other departments or agencies:** | **Impact Assessment (IA)**<br>**IA No:**<br>**Date:** 26 July 2010<br>**Stage:** Consultation<br>**Source of intervention:** Domestic<br>**Type of measure:** Primary legislation<br>**Contact for enquiries:**<br>financial.reform@hmtreasury.gsi.gov.uk |

## Summary: Intervention and Options

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

The tripartite system of financial regulation failed to ensure financial stability - in particular by failing to identify the risk posed by the rapid and unsustainable increase in debt in the economy. This resulted in considerable economic costs in lost output and in a substantial deterioration in public finances. The regulatory system cannot be restructured without primary legislation.

**What are the policy objectives and the intended effects?**

The policy objective is to reform the regulatory system for financial services to avoid a repeat of the financial crisis. The legislation will create a Financial Policy Committee in the Bank of England to take charge of macro-prudential regulation. It will also replace the Financial Services Authority (FSA) with two properly focused regulators. A prudential regulation authority (PRA) (which will be a subsidiary of the Bank of England) will conduct the prudential regulation of deposit-takers, insurers and investment banks. A consumer protection and markets authority (CPMA) will be responsible for consumer protection in financial services and the regulation of conduct of business, including the conduct of firms supervised by the PRA and secondary market conduct more generally.

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

This is a consultation stage impact assessment intended to provide an assessment of the Government's proposals for reform of financial regulation. The options considered are the "do nothing" option (i.e. not to proceed with the proposed reforms) and proceeding with the proposed reforms (the "proceed" option). There are a number of variants in the proceed option based on different allocations of particular FSA functions or regulated firms between the PRA and CPMA, or other bodies. These are not considered further at this stage. It is impossible quantify the benefits of the proceed option in a realistic way. The main quantifiable costs are one-off transitional resource costs for: (1) the Treasury, Bank of England, FSA, CPMA and PRA in the public sector; and (2) for those firms which will be supervised both PRA and CPMA. There may also be some extra ongoing costs for firms and regulators. There should be no significant increase in costs for the majority of firms which will be supervised only by the CPMA. The benefits from reducing the frequency or severity of financial crises such outweigh the additional resource costs.

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| **When will the policy be reviewed to establish its impact and the extent to which the policy objectives have been achieved?** | Not applicable |
| **Are there arrangements in place that will allow a systematic collection of monitoring information for future policy review?** | Not applicable |

**SELECT SIGNATORY Sign-off** For consultation stage Impact Assessments:

***I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.***

Signed by the responsible Minister: ................. Date:.......................................

## Summary: Analysis and Evidence

Policy Option: proceed

**Description:**

Proceeding with proposed reforms

| Price Base Year 2010 | PV Base Year 2010 | Time Period Years n/a | Net Benefit (Present Value (PV)) (£m) | | |
|---|---|---|---|---|---|
| | | | Low: | High: | Best Estimate: N/A |

| COSTS (£m) | Total Transition (Constant Price) | Years | Average Annual (excl. Transition) (Constant Price) | Total Cost (Present Value) |
|---|---|---|---|---|
| Low | | | | |
| High | | | | |
| Best Estimate | See text | | See text | See text |

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

Transition costs spread over 2-3 years for the Treasury, Bank of England, FSA, CPMA and PRA in setting up the new institutional arrangements.
Transition costs, probably mainly in years 3 and 4 for firms supervised by PRA and CPMA in future. These will be estimated more accurately based on consultation responses.

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

None

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

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

Benefits cannot be monetised (see evidence base).

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

Reduction in frequency and severity of financial crises in the UK. This is a benefit for the UK economy as a whole rather than for specific groups. There may also be collateral benefits for the rest of the world.

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

The key assumptions for this assessment are those made for the non-quantifiable benefits of a reduction in the frequency and severity of financial crises. The main sensitivities in relation to quantifiable costs are that (1) the costs of (or time taken in) setting up the new regulatory arrangements are materially underestimated; and (2) that any additional ongoing costs of financial regulation incurred by the PRA or CPMA, or by regulated persons are materially underestimated. The risk that these underestimates could be large enough to outweigh the benefits is considered to be small.

| Impact on admin burden (AB) (£m): | | | Impact on policy cost savings (£m): | In scope |
|---|---|---|---|---|
| New AB: N/A | AB savings: N/A | Net: N/A | Policy cost savings: | N/A |

## Enforcement, Implementation and Wider Impacts

| | | | | | |
|---|---|---|---|---|---|
| What is the geographic coverage of the policy/option? | | | United Kingdom | | |
| From what date will the policy be implemented? | | | 1 January 2013 (provisional) | | |
| Which organisation(s) will enforce the policy? | | | Not applicable | | |
| What is the annual change in enforcement cost (£m)? | | | Not applicable | | |
| Does enforcement comply with Hampton principles? | | | Yes | | |
| Does implementation go beyond minimum EU requirements? | | | N/A | | |
| What is the $CO_2$ equivalent change in greenhouse gas emissions? (Million tonnes $CO_2$ equivalent) | | | **Traded:** N/A | | **Non-traded:** N/A |
| Does the proposal have an impact on competition? | | | No | | |
| What proportion (%) of Total PV costs/benefits is directly attributable to primary legislation, if applicable? | | | **Costs:** 100 | | **Benefits:** 100 |
| Annual cost (£m) per organisation (excl. Transition) (Constant Price) | **Micro** | **< 20** | **Small** | **Medium** | **Large** |
| Are any of these organisations exempt? | No | No | No | No | No |

## Specific Impact Tests: Checklist

| Does your policy option/proposal have an impact on…? | **Impact** | **Page ref within IA** |
|---|---|---|
| **Statutory equality duties** Statutory Equality Duties Impact Test guidance | No | N/A |
| **Economic impacts** | | |
| Competition Competition Assessment Impact Test guidance | No | 6 |
| Small firms Small Firms Impact Test guidance | No | 7 |
| **Environmental impacts** | | |
| Greenhouse gas assessment Greenhouse Gas Assessment Impact Test guidance | No | N/A |
| Wider environmental issues Wider Environmental Issues Impact Test guidance | No | N/A |
| **Social impacts** | | |
| Health and well-being Health and Well-being Impact Test guidance | No | N/A |
| Human rights Human Rights Impact Test guidance | No | N/A |
| Justice system Justice Impact Test guidance | No | N/A |
| Rural proofing Rural Proofing Impact Test guidance | No | N/A |
| **Sustainable development** Sustainable Development Impact Test guidance | No | N/A |

# Evidence Base

## References

| No. | Legislation or publication |
|---|---|
| 1 | Financial Secretary’s statement to Parliament: 17 June 2010: Hansard (Commons) Col 1056 |
| 2 | Financial Secretary’s written ministerial statement: 26 July 2010. |

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

| | $Y_0$ | $Y_1$ | $Y_2$ | $Y_3$ | $Y_4$ | $Y_5$ | $Y_6$ | $Y_7$ | $Y_8$ | $Y_9$ |
|---|---|---|---|---|---|---|---|---|---|---|
| **Transition costs** | | | | | | | | | | |
| **Annual recurring cost** | | | | | | | | | | |
| **Total annual costs** | See main evidence base text below | | | | | | | | | |
| **Transition benefits** | | | | | | | | | | |
| **Annual recurring benefits** | | | | | | | | | | |
| **Total annual benefits** | | | | | | | | | | |

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

## Introduction

This section sets out the assumptions supporting this consultation stage impact assessment and sets out the information which is sought from consultees. The impact assessment should be read in conjunction with the rest of the consultation document. The Government would also welcome any general comments on the impact assessment.

## Problem under consideration/Rationale for intervention/Policy objective

The tripartite system of financial regulation failed to ensure financial stability in the UK in 2007 and 2008. As a result there was the longest and deepest recession since the Second World War and a record budget deficit. The policy objective is to reduce the frequency and severity of financial crises.

## Description of options considered

There are two options: “do nothing” and “proceed” with the proposed reforms. Within the proceed option there are number of variants mainly relating to the allocation of particular functions between the PRA and CPMA. These are not considered further in this impact assessment but may be examined in the final impact assessment, depending on the results of consultation.

In the proceed option:

- a new Financial Policy Committee will be established in the Bank of England to have responsibility for considering the macro-economic and financial issues that may threaten financial stability;
- the Bank of England will have responsibility for the regulation of settlement systems and central counterparty clearing houses to sit alongside its existing responsibilities for payment system oversight;
- a prudential regulation authority (PRA) will be established as a subsidiary of the Bank of England to have responsibility for the prudential regulation of deposit-takers, insurers and broker-dealers (investment banks);
- a consumer protection and markets authority (CPMA) will be established to have responsibility for consumer protection in financial services and for regulating conduct in financial services, including in relation to firms authorised and supervised by the PRA. A CPMA markets division will lead on market conduct regulation. The CPMA will also be responsible for the regulation (including prudential regulation) of all firms not regulated by the PRA, including most investment firms, investment exchanges and providers of trading facilities, and the provision of consumer credit.

The Government is also considering whether the UK Listing Authority (UKLA) should be merged with the Financial Reporting Council (FRC) under the Department for Business, Innovation & Skills, or whether it should remain within the CPMA markets division.

## Costs and benefits of each option

### *Introduction*

This impact assessment only covers two options: "do nothing" and "proceed". The costs and benefits can be compared by taking the do nothing option as the base case and measuring the costs and benefits of the proceed option from there. The costs and benefits discussed below are the costs and benefits of the proceed option.

This approach is straightforward for assessing the benefits since they may be assumed to arise only in the proceed option.

For the purposes of assessing the costs solely of the proposed changes to the regulatory structure, it is assumed that no changes will be made to the rules etc of the regulatory bodies. This is an unrealistic assumption but it can be justified because:

a) certain rule etc changes will take place regardless of any changes to regulatory structure. This is most obviously the case for changes made in order to implement changes made in EU law. The costs and benefits of these changes will therefore be the same in both the do nothing and the proceed options and may be ignored in the comparison of the two options;

b) other rule changes will be the subject of cost benefit analysis before they are made and may be assumed to deliver positive net benefits. Assuming no rule changes are made therefore means that the costs of the proceed option are overstated.

### *Costs – Treasury, Bank of England, FSA, CPMA and PRA*

The transitional costs for the Treasury, Bank of England, FSA, CPMA and PRA are largely the additional resource costs of developing and bringing in the necessary primary and secondary legislation, and of implementing the reforms by administrative measures. Based on preliminary estimates from the bodies concerned, this is expected to be of the order of £50 million spread over about 3 years.

The ongoing costs of the reforms will be mainly resource costs incurred by the PRA and CPMA. These will differ in the proceed option from the costs the FSA would incur in the do nothing option for three reasons: (1) changes in supervisory practice by the new regulators; (2) improvements in operating efficiency because of increased specialisation in the new regulators; and (3) losses of economies of scale due to the need to duplicate certain fixed costs in the new regulators. Increased specialisation is unlikely to be a significant source of savings as the FSA is probably large enough to ensure that there is a critical mass in both areas relevant to the CPMA and PRA. Some loss of economies of scale due to duplication of fixed costs is inevitable but, as both the CPMA and the PRA should be large enough to ensure sufficient scale of operation in key areas, there should not be any substantial increases in ongoing costs. There should be no significant additional ongoing costs in respect of functions transferred to the Bank of England or arising from the Financial Policy Committee (FPC).

The FSA is working with the Bank of England to determine the most appropriate operating model for the new regulators and has appointed KPMG to do a value-for-money study. Changes in supervisory practice could increase or reduce costs.

There should be no additional ongoing costs for the Treasury itself in the proceed option once the reforms have been implemented.

The impact assessment therefore assumes that there will be no significant additional ongoing costs for the Treasury, Bank of England, CPMA and PRA overall after the reforms have been implemented.

### *Costs – regulated firms*

Most of the approximately 20,000 firms currently regulated by the FSA will be regulated solely by the CPMA after the reforms have been implemented. These firms are unlikely to suffer any significant transitional costs or significant increases in ongoing costs as a result of the reforms.

About 1,500 – 2,000 firms are likely to prudentially supervised by the PRA while also subject to conduct of business regulation by the CPMA. These firms are likely to incur transitional costs in making arrangements to deal with two regulators rather than one and may face higher ongoing costs.

There are about 100 – 200 groups containing both PRA and CPMA firms which may be affected in the same way as PRA firms by higher transitional or ongoing costs. The Government will also be considering whether to extend supervisory powers to cover currently unregulated holding companies and unregulated entities within the group structure of financial institutions such as banks and insurers.

Most PRA firms will be large banks, insurance companies and investment banks and it may be reasonable to assume that the effect on ongoing costs for these firms will be minimal. (Most groups which contain PRA firms are likely to be large or to contain large firms of these types.) Large firms or groups will already have significant regular interaction with the FSA on prudential and conduct of business matters and replacing that with regular interaction with separate regulators of prudential and conduct of business may not be great. On the other hand, these firms or groups are likely to incur more significant transitional costs in setting up systems to deal with both regulators.

As well as certain large firms, the PRA will also be responsible for prudentially supervising much smaller firms which take deposits or effect and carry out contracts of insurance. Almost all credit unions and some friendly societies and building societies would fall to be considered as small firms. These firms are likely to suffer some increase in ongoing costs as a result of having to deal with two regulators but the transitional costs seem likely to be relatively less.

**The Treasury would welcome comments from consultees on the assumptions made about transitional and ongoing costs for all types of firm. In particular, comments are sought from all types and size of deposit-taking, insurance and investment banking firms (including credit unions and friendly societies), and from groups containing such firms.**

*Benefits*

In principle, the benefits can be estimated by calculating the change in the present value of the total expected welfare losses from financial crises due to the reduction in the frequency and severity of financial crises. In practice, any such estimates would be entirely dependent upon the assumptions made. As the Bank of England notes in its Financial Stability Report for June 2010: “History suggests, however, that financial crises have often been extremely costly, with significant output losses and scarring effects that permanently reduce the level of output. For example, the IMF estimate that output remains 10% below its pre-crisis trend seven years after the start of a typical systemic crisis. So even if the probability of crises can be reduced slightly, the potential gains would be large. And there might be additional welfare benefits deriving from greater stability in a regime with less frequent crises.”.[1] The Government considers therefore that the benefits of the proceed option are likely to outweigh the costs by a significant margin.

## Risks and assumptions

The principal assumptions are those relating to the costs and benefits of a financial crisis (see above). The main risks are (1) that the transitional costs (i.e. development and implementation costs) for regulatory bodies or firms are materially underestimated (including the risk that implementation takes longer than anticipated); and (2) that the ongoing costs for regulatory bodies and firms are materially underestimated. These are real risks but the Government considers that the margin of benefits over costs is such that it is most unlikely that the implementation costs could increase by the amount necessary to reverse the ranking of the proceed and do nothing options.

## Administrative burden and policy savings calculations

See costs and benefits of each option.

## Wider impacts

The Government does not consider that the proposed reforms will have any effect in relation to: race, disability and gender equality or in respect of any requirements relating to Northern Ireland; greenhouse gases, wider environmental issues, health and well-being, human rights, the justice system, rural proofing and sustainable development.

The principal effect on competition from financial services regulation is through the effect on barriers to entry into the industry. The Government does not envisage that the proposed reforms to regulatory structure will in themselves change the conditions which firms have to satisfy to obtain authorisation from a regulator but there may be higher costs in obtaining authorisation for firms that need to apply to the PRA as that body will also need to consult the CPMA on certain aspects of the application. The

[1] Bank of England Financial Stability Report, June 2010, Box 7, page 58.

Government does not expect these costs to be significant and there would in any event be no effect upon the ability of EEA firms to enter the UK market using a “passport” from their home State regulator issued under the relevant EU Directives. The Government does not consider, therefore, that the proposed reforms will have any significant effect on competition.

Small firms which take deposits or effect or carry out contracts of insurance will be regulated by the PRA and CPMA. The proposed reforms are likely to have some effect on their costs (see above). Most small firms in the financial services industry are not deposit-takers or insurers and will be regulated by the CPMA in succession to the FSA. They are not likely to be materially affected by the proposed reforms.

## Summary and preferred option with description of implementation plan

The Government’s preferred option is to proceed with the proposed reforms. The main implementing measure will be primary legislation which is expected to be enacted in 2012. Secondary legislation and administrative measures (including action by the Bank of England and the FSA) will be needed to complete implementation which is assumed, for the purposes of this impact assessment, to be essentially completed by 1 January 2013.

## Annex 1: Post Implementation Review (PIR) Plan

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

| |
|---|
| **Basis of the review:** The Government will consider arrangements for post-implementation review at a later stage. |
| **Review objective:** |
| **Review approach and rationale:** |
| **Baseline:** |
| **Success criteria:** |
| **Monitoring information arrangements:** |
| **Reasons for not planning a PIR:** |