Title: A Smarter Ring-fencing Regime **SI (Statutory Instrument) No:** [XXX] **Other departments or agencies:** The Prudential Regulation Authority is responsible for maintaining most ring-fencing requirements in its rulebook and is in parallel making changes to support the reforms being made by HM Treasury. The Financial Conduct Authority is responsible for maintaining a small number of rules relating to the ring-fencing regime. **Contact for enquiries**: Naomi.Russell@hmtreasury.gov.uk	De minimis assessment **Date:** 11/11/2024 **Type of regulation:** Domestic **Date measure comes into force:** 21 days after making.
Cost of Preferred (or more likely) Option (-) £20 m (calculated as £2m/annum over 10 years) The reforms will improve outcomes for banks and their customers by making the ring-fencing regime more flexible and proportionate, whilst maintaining appropriate financial stability safeguards and minimising risks to public funds.	**Equivalent Annual Net Direct Cost to Business per year** (EANDCB in 2022 prices) **(-)£2m per year**

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

Background on the ring-fencing regime:

Following the Global Financial Crisis (GFC) of 2007-08, HM Treasury, on the recommendation of the Independent Commission on Banking (ICB), established a ring-fencing regime for large banks in the UK. The regime was legislated for in the Financial Services (Banking Reform) Act 2013. The regime came into full effect on 1 January 2019. The government made two Orders under the Financial Services and Markets Act (FSMA) 2000, which set the detailed calibration of the ring-fence:

i. *The Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order (CAO) 2014[1];* and
ii. *The Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order (EAPO) 2014.[2]*

The regime's objectives, as outlined by the ICB, are to "make it easier to sort out both ring-fenced banks and non-ring-fenced banks which get into trouble, without the provision of taxpayer-funded solvency support" and to "insulate vital banking services on which households and SMEs depend from problems elsewhere in the financial system".[3] Ring-fencing requires the largest UK banks to separate core retail banking from investment banking in order to support financial stability by making banking groups simpler and easier to 'resolve'. This means that if either the ring-fenced or non-ring-fenced part of the bank fails, it will be easier to manage the failure in an orderly way without the need for a government bail-out. The general aim of the ring-fence is to keep retail

[1] The Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order (CAO), 2014 amended by SI 2016/1032 and SI 2018/897).
[2] The Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order (EAPO), 2014 (amended by SI 2016/1032) .
[3] Independent Commission on Banking (nationalarchives.gov.uk), September 2011.

banking operations separate from investment banking operations, so as to achieve this objective of improved financial stability and to protect public funds in the event of a banking failure.

The key parameters of the ring-fence, as set in the Core Activities Order and Excluded Activities and Prohibitions Order, are:

- **Scope**: Banking groups with more than £25bn of "core deposits", defined as UK or EEA retail and SME deposits, must comply with the regime. They are required to separate their retail and investment banking activities into a ring-fenced body (RFB) and a non-ring-fenced body (NRFB) and hold core deposits within the RFB.
- **Excluded Activities**: RFBs are prohibited from dealing in investments and commodities as principal, with the exceptions of dealing in investments to manage their own risks and to sell simple derivatives to their customers.
- **Prohibitions**: RFBs cannot have exposures to "relevant financial institutions" (RFIs), such as NRFBs, investment firms, globally systemically important insurers (GSIIs), and investment funds. They can provide specified products including trade finance products. They are largely prohibited from operating outside the EEA.

The Financial Services (Banking Reform) Act 2013 FSBRA required the government to commission an independent review of the regime within two years of it coming into full effect.

Findings of the independent review:

The review was undertaken by a panel of independent experts led by Sir Keith Skeoch and delivered its final report in March 2022.[4] It found that the ring-fencing regime was worth retaining at present, but also made a series of recommendations to reduce the rigidity of the existing regime and address unintended consequences. These recommendations were designed to make the regime more adaptable, simpler, and better placed to serve customers, while continuing to protect financial stability and minimising risks to public funds. The final report made seven recommendations related to ring-fencing:

1. Change the scope of the ring-fencing regime to focus on large, complex banks.
2. Align the ring-fencing regime with the resolution regime.
3. Adjust the restrictions on servicing relevant financial institutions (RFIs).
4. Improve the operation of the ring-fencing regime through technical amendments.
5. Remove the blanket geographical restrictions from legislation that prevent RFBs from establishing operations or servicing customers outside of the EEA.
6. Review the excluded activities under the ring-fencing regime.
7. The Bank of England should ensure that sufficient plans are in place as part of its contingency planning to provide liquidity to NRFBs in a stress scenario.

This Impact Assessment: The Smarter Ring-fencing Reforms:

This impact assessment covers the Smarter Ring-fencing Reforms, which take forward five of the review's recommendations. These five areas of reform were designed to introduce quick improvements to the functionality of the regime that could be implemented through secondary legislation and are included in this SI. Recommendations 2 and 7, as listed above, are not addressed in this SI. Recommendation 2 was to consider the long-term alignment of the resolution and ring-fencing regime, on which the previous government undertook a separate call for evidence. Recommendation 7 is directed at The Bank of England.

[4] Ring-fencing and Proprietary Trading Independent Review Final Report, March 2022.

The government is taking forward a set of reforms through the SI, many of which take forward recommendations from the Skeoch review, to improve the regime. The development of these reforms was informed by the work undertaken by the review panel, stakeholder feedback and the joint HM Treasury and Bank of England Ring-fencing Taskforce.

Failing to implement these reforms would have a significant opportunity cost for the banking sector, banking customers, and the UK economy more broadly. While the direct impacts are limited, the government assesses the reforms will indirectly improve the products and services offered to RFBs' customers in the UK and internationally, helping the UK banking sector to remain agile, competitive, and profitable, and boosting its attractiveness to inward investment.

2. What are the policy objectives and the intended effects?

The Smarter Ring-fencing Reforms represent a significant evolution in the ring-fencing regime. While they have limited direct impact, they create new optionality for banks with the eventual benefits depending on their commercial decisions. There are 26 proposals included in this package of reforms; 23 of those proposals will create flexibility for RFBs to provide new products/services or undertake new activities which they may, or may not, choose to utilise. Regarding the two proposals that will have a direct impact, the first is the secondary threshold, which will have a direct monetary benefit to businesses (which has been included in our overall assessment of the monetary impacts). The second is the removal of the Notice of Determination requirement which may have a negligible direct impact.

The 26 proposals intend to make changes relating to four broad categories: ring-fencing thresholds (Section A), architectural reforms (Section B), permitted products and services (Section C), and definitions and technical amendments (Section D). Each proposal has been allocated to one of the four sections.

For each reform, the objectives and intended effects are outlined below.

To note, for the five most material changes we have included logic chains (here in section 2) and a detailed assessment of the direct costs and benefits of the changes (section 4). These changes are A.1 the deposit threshold, A.2 secondary threshold, B.1 Geographic restrictions, C.1 Equity investments and C.2 Exposures to certain small financial institutions. These material changes will incentivise banks to make relatively larger changes to their behaviour compared to the other measures, largely by way of their overall business structures. However, most of the changes (excluding B.1) are still optional for the affected banks. The below list outlines how the policy in this SI provides material new options for banks. Section 2 expands on the effects themselves, while section 4 explains why material changes have been assessed as having a direct effect of under £5m.

- **A1: Deposit threshold**: *Banks currently below the £25bn deposit threshold will have the option to grow their deposits of up to £35 billion before ring-fencing requirements would apply. Based on the consultation responses, we expect that banks will choose to take advantage of this additional growth.*
- **A2: Secondary threshold**: *This measure will directly result in two banks becoming exempt from the ring-fence regime. This will have a direct positive impact on their costs.*
- **B1: Geographic restrictions**: *RFBs will have the option to establish operations globally, which offers a wide range of new options to their businesses.*
- **C1: Equity investments**: *This change will allow RFBs to make direct and indirect investments into SMEs up to 10% of their tier 1 capital.*
- **C2: Exposures to certain small financial institutions:** *RFBs will be permitted to have exposures to relevant financial institutions (RFIs) that are SMEs. It will improve access to banking services for RFIs and reduce the compliance burden placed on RFBs.*

Section A: Reforms to the threshold

A.1 Deposit Threshold

The government is increasing the level of retail and SME deposits a bank can hold before it is subject to the ring-fencing regime, known as the core deposit threshold. It will be increased by £10bn from £25bn to £35bn. HM Treasury recognised at the time of setting the £25 billion deposit threshold that it may need to be adjusted over time to reflect market developments[5]. The £10bn increase is informed by a number of relevant economic indicators such as inflation and growth in the deposit base.

The aim of increasing the threshold is to increase competition in the UK and remove a barrier to growth for smaller banks. The government anticipates that banks close to the existing deposit threshold will expand their core deposits following the uplift, which is supported by the responses given during the consultation. The expansion would allow smaller, growing banks operating in the UK market more headroom to grow before being subject to the costs of ring-fencing. The increased participation is expected to increase competition for deposits, benefitting depositors.

The reform may also encourage inward investment into the UK as new entrants to the UK banking market will have more room to grow and develop economies of scale before becoming subject to the regime.

There will be no direct impact from this change as there are currently no banks that are subject to the regime that hold between £25-£35bn of core deposits. There will likely be several indirect impacts which are illustrated in Logic Link One.

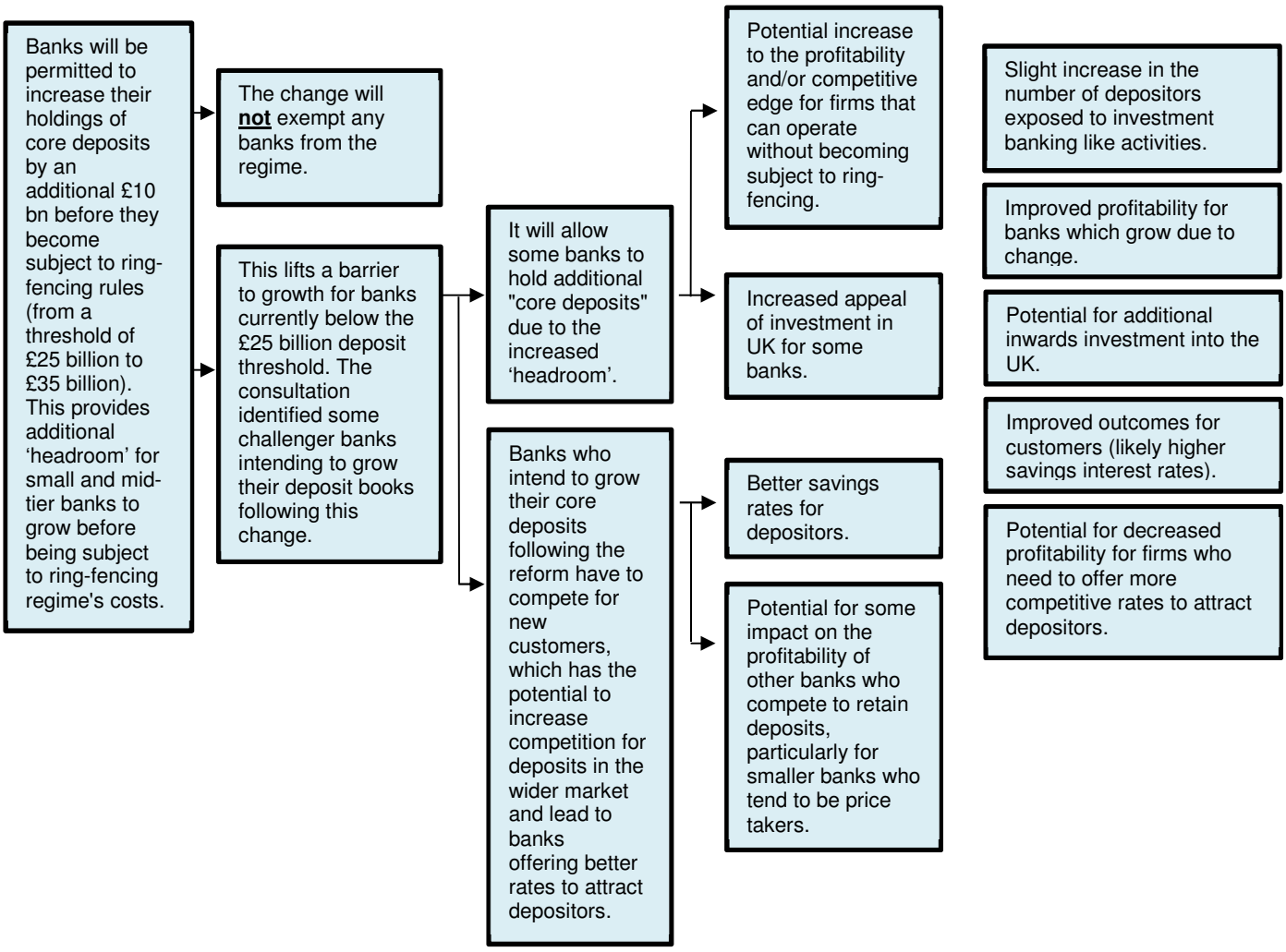
As illustrated, we anticipate indirect impacts from increased competition for deposits. Banks will be incentivised to offer higher interest rates and a better consumer experience to attract depositors, leading to better outcomes for SMEs and retail customers. In parallel, banks currently not subject to ring-fencing will be able to grow further before potentially becoming subject to the regime. Lastly, due to potential increased competition for deposits, some banks may experience decreased profitability due to higher costs of funding.

Regarding financial stability, the Treasury originally intended to exclude smaller banks from ring-fencing due to the disproportionate costs of compliance relative to the financial stability benefits. Since the threshold was initially calibrated, the regulatory landscape has evolved e.g., the development of the UK's resolution regime, and higher liquidity and capital requirements for banks. Given the improvements in the resilience of the banking sector, the appropriate size of this threshold – below which the costs of compliance with the ring-fencing regime would outweigh the financial stability benefits – has increased.

It would result in approximately 90% of banks' UK retail deposits being covered by the ring-fencing deposit threshold, which is broadly in line with the proportion covered when the threshold was set originally.

[5] Banking reform: delivering stability and supporting a sustainable economy (nationalarchives.gov.uk), para 2.85, June 2012

Logic Link One:



A.2 Secondary Threshold

The reforms introduce a secondary threshold which creates an exemption from the ring-fencing regime for retail focused banks. This exemption applies to banks which meet the core deposit threshold but are not a Global Systemically Important Bank (GSIB) and do not carry out a material amount of investment banking activity. The measure for investment banking activity is holding UK trading assets which amount to less than 10% of their tier 1 capital (as an average over 3 years), as shown in the formula below.

$$\frac{\text{trading assets (excluding those acquired under article 6(2) EAPO)}}{\text{tier 1 capital}} = 10\%$$

This change will alleviate an unnecessary regulatory burden on banks that are almost entirely retail-focused. This should support domestic competition by removing ring-fencing requirements from retail-focused banks and removing a barrier to growth for smaller, growing banks.

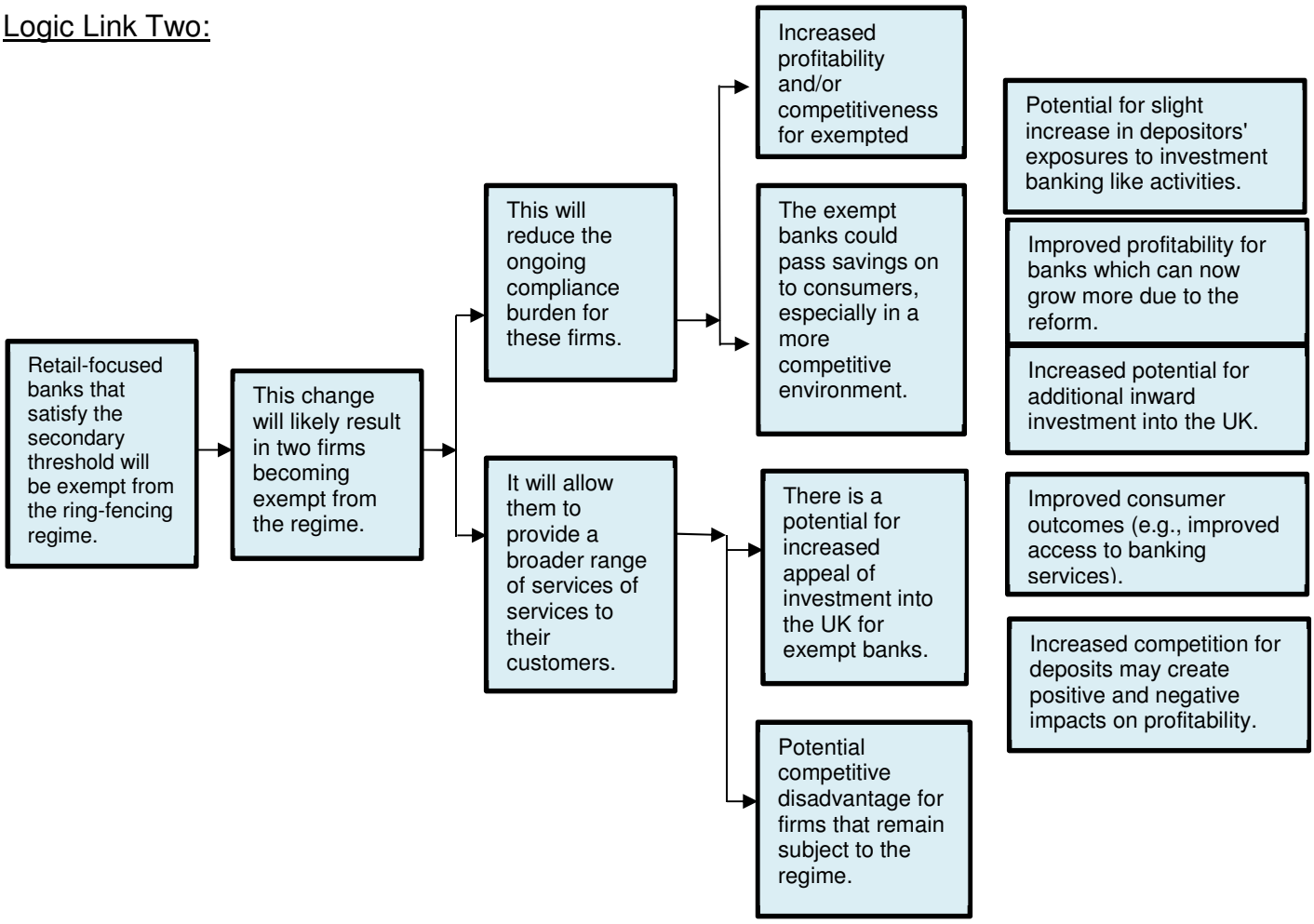
The impacts of this change are illustrated in Logic Link Two. We expect it will have a direct impact on two banks that are currently subject to the regime who we assess will become exempt because of this reform. In response to the previous government's September 2023 consultation, one of

these banks confirmed that this would save them c.£1m per year in compliance and administrative costs as they would no longer be subject to the regime.

There will also be indirect impacts. RFBs that become exempt from the regime through the secondary threshold will, if they choose to, be able to offer a wider range of products as the ring-fencing regime's restrictions will no longer apply. The ability to undertake a wider range of business outside of the ring-fencing regime may also encourage inward investment in the UK (noting that this would be limited to retail-focused banks in this case). There is potential for a slight competitive disadvantage for firms that remain subject to the regime however neither of the two ring-fenced groups who we expect will become exempt have any material NRFB operations. Therefore, the impact will likely be limited.

Regarding financial stability, HM Treasury and the PRA have undertaken joint analysis and have concluded that there is no material increase in financial stability risks. This is because banks that become exempt from the regime would need to maintain their investment banking-like activity below the secondary threshold, limiting their ability to undertake risker activities which in turn limits the risks they face.

Logic Link Two:



A.3 De minimis threshold

The objective of this reform is to address the compliance burden relating to small breaches of the RFI exposure prohibition. Since the RFI SME exemption will apply to four types of RFI, RFBs would still be subject to the existing exposure restrictions for other types of RFI, despite this being one of the main sources of the compliance burden for firms.

The reform will permit RFBs to have exposures to RFIs, allowing them to incur an exposure of up to £100k per RFI (e.g., other banks, large asset managers, and structured finance vehicles).

This change helps to address the disproportionate compliance and administrative burden RFBs face in relation to small breaches of this prohibition, where an RFB inadvertently incurs an exposure to an RFI e.g., a credit card. The majority of breaches are often of immaterial value relative to the financial stability goals of the ring-fencing regime. After this change RFBs will not be required to report exposures below £100k to the PRA, which will reduce the administrative burden placed on RFBs.

The purpose of the RFI exposure prohibition is to reduce the interconnectedness and exposure of RFBs to the wider financial system, protecting them from external shocks. The government's assessment is that such small exposures pose little risk to the financial stability of the RFBs and wider economy.

Section B: Architectural Reforms

B.1 Geographical restrictions

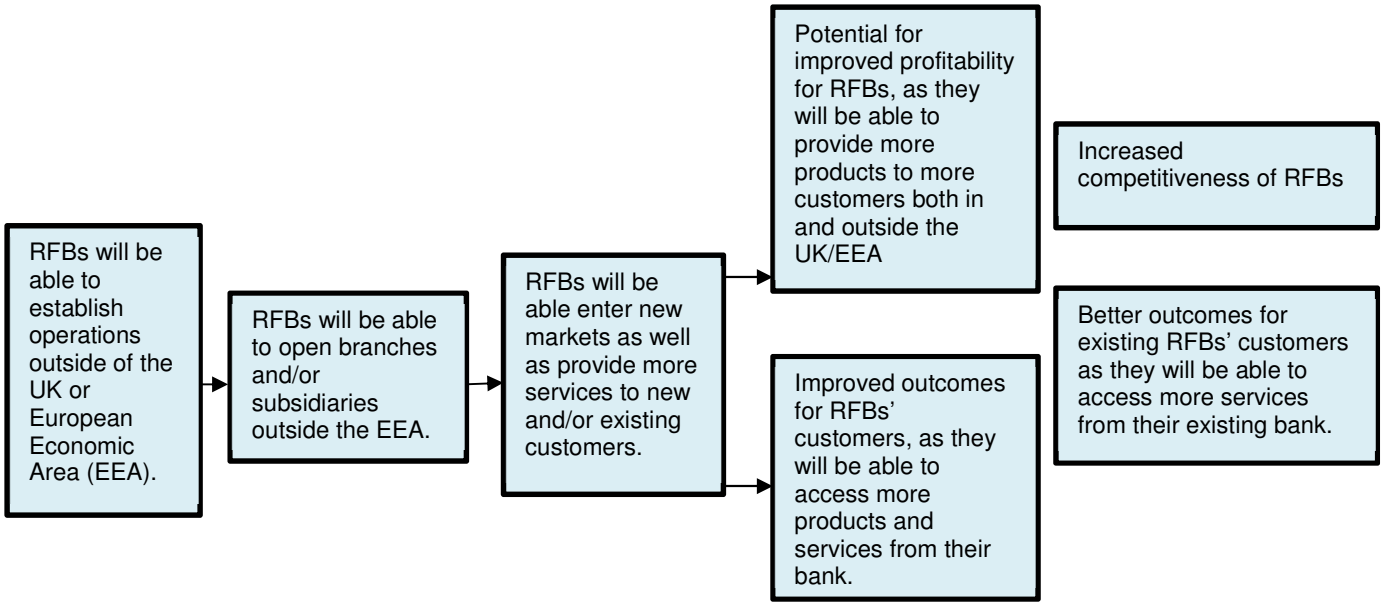
RFBs are broadly only permitted to operate branches and subsidiaries in the UK and EEA. These reforms will allow RFBs to operate subsidiaries or branches globally, under appropriate PRA supervision and monitoring. In parallel, the definition of core deposits (i.e., those used to calculate the deposit threshold) will now only capture those held in UK accounts.

This reform will support RFBs to compete internationally and UK businesses operating abroad, as the former will be permitted to enter new markets. In turn, RFBs will be able to better support their UK and EEA clients in new markets.

The current regime limits RFBs' ability to service their UK customers both domestically and outside the EEA, which may also hamper the facilitation of international trade as a UK-based company may not be able to rely on one banking relationship to support its operations abroad.

There are no direct impacts of this change, but there are indirect impacts which could materialise if banks utilise this change, which are illustrated in Logic Link Three. The government anticipates that because of these changes UK RFBs will be more competitive, both domestically and internationally. Additionally, RFB customers should benefit from increased access to services as RFBs seek to compete for their business, meet demand, and provide new products and/or services.

Logic Link Three:



B.2 Merger & Acquisitions

If a bank crosses the core deposit threshold and becomes subject to the ring-fencing regime, it is allowed a four-year transition period to comply with the regime's requirements. However, there is currently no transition period for when a RFB wishes to acquire another bank that is not subject to ring-fencing (outside of a resolution scenario). These reforms address this and will provide a four-year transition period in the scenario where a ring-fenced banking group acquires a bank that is not subject to the ring-fencing regime.

While this reform has no direct impact, it will provide flexibility to ring-fenced groups so that they can, in future, pursue commercial opportunities via mergers or acquisitions. The potential financial stability risks of this reform are limited by other regulatory regimes such as the prudential and resolution frameworks, PRA supervision of the transaction and any conditions they may attach to it, and the acquiring bank's own due diligence.

Lastly, this reform will support the ring-fencing regime's financial stability objectives as it will permit an RFB to acquire a bank that is in financial difficulty, thus potentially avoiding a resolution scenario.

Section C: Changes to permitted products and services

C.1 Equity investments in SMEs

The reforms permit RFBs, within limits, to make both direct and indirect equity investments in SMEs. Under the proposals, RFBs will be able to: i) make direct minority equity investments in UK SMEs; ii) make investments in funds which invest a minimum of 50% of their capital in UK SMEs; and iii) acquire instruments like equity warrants when providing loans to UK SMEs. The proposal caps the total value of investment across these three types of activities to 10% of an RFB's tier 1 capital.

These changes are designed to support the growth of UK SMEs by encouraging RFBs to finance and invest in them. The changes relating to options/warrants are designed to incentivise RFBs to provide loans to SMEs. RFBs at end-2023 held approximately £96bn of tier 1 capital, meaning the

equivalent of up to 10% of this could be committed to making investment in UK SMEs either directly or indirectly.

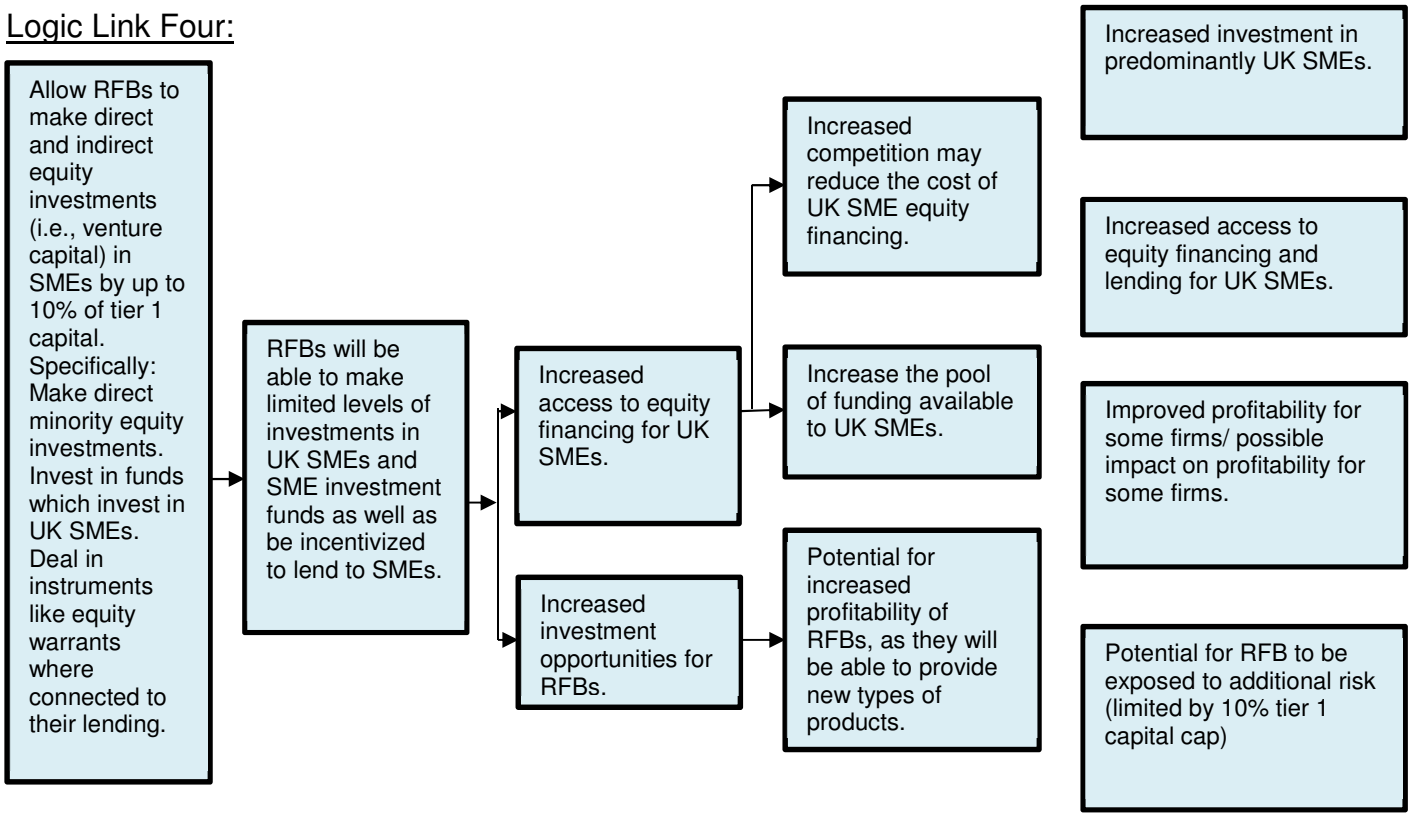
RFBs typically own the commercial banking relationships with SMEs. This pre-existing relationship means they have a good understanding of SMEs' needs and are best placed, when compared to NRFBs, to manage a broader commercial relationship with them.

There are no direct impacts of this change, but there are a number of potential indirect impacts contingent on subsequent RFB commercial decisions, as set out in Logic Link Four.

The government anticipates that RFBs will take advantage of these changes, supporting the growth of UK SMEs. This will result in increased access to equity financing and lending for SMEs. This in turn should benefit the wider UK economy, innovation, and employment, in line with the government's wider economic priorities. The government further anticipates this will also have a slight distributional impact between banks, with some benefiting from increased profitability.

The cap (10% of tier 1 capital) on the level of investment RFBs can make in these activities limits the prudential risks, which are further mitigated by the relatively high capital requirements that would apply to such investments. The reform should therefore not result in materially increased risks to financial stability.

Logic Link Four:



C.2 Exposures to certain small financial institutions

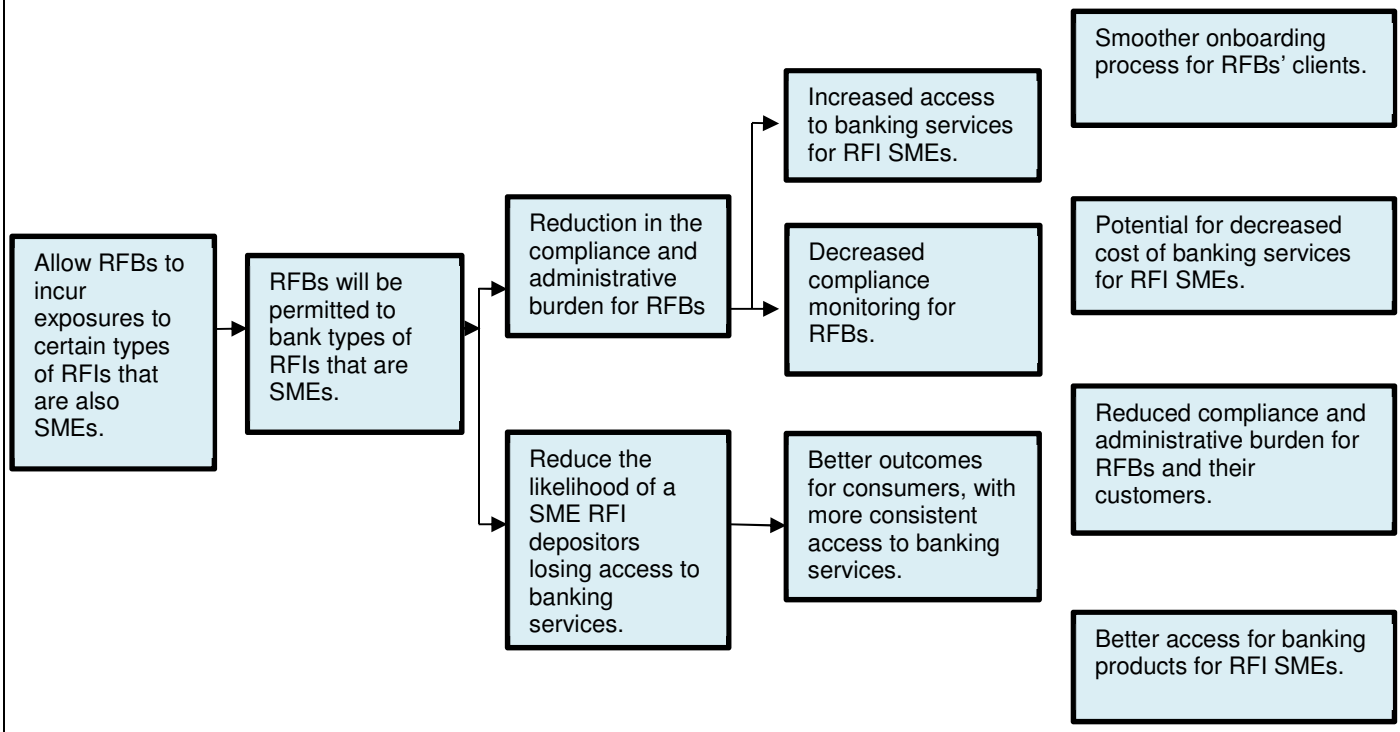
RFBs are currently prohibited from incurring exposures to RFIs; the reforms permit RFBs to have exposures to certain types of RFIs (management companies, alternative investment fund managers (AIFMs), UCITS, AIFs, mixed financial holding companies, and financial holding companies) that qualify as SMEs. The reasons for this are twofold. Firstly, RFBs are currently subject to a high administrative and compliance burden as they must constantly monitor for exposures to RFIs and report any that are identified to the PRA.

Secondly, a broad range of financial institutions are captured by the RFI definition, which does not account for the size of an RFI. This has resulted in smaller, low-risk RFIs finding it difficult to access bank services as NRFBs generally do not provide banking services to SMEs.

The prohibition on RFI exposures was designed to reduce financial interconnectedness and RFBs' exposure to shocks in the wider financial system that would undermine the objectives of the ring-fencing regime. Permitting exposures to certain RFIs that are SMEs with these reforms will not undermine these objectives since those RFIs will not be high-risk due to their size and the type of exposure is limited by the regime's other requirements.

The intention of this policy is therefore broadly twofold: i) to improve access to banking services for RFI SMEs as RFBs are generally better placed, given their business model, to provide services to SMEs; and ii) to reduce the compliance and administrative burden placed on RFBs. It will be a commercial decision for RFBs to onboard these types of customers.

Logic Link 5:



C.3 Trade finance

The current regime prevents RFBs from offering certain types of standard trade finance products. This reform allows RFB to enter market-standard trade finance arrangements outside the scope of the current exemption, e.g., standby letters of credit.

The objectives are to give RFBs the commercial freedom to offer more products and to introduce increased competition into the trade finance market. This change places no obligations on firms, but the government assesses it should lead to greater competition in the trade finance market, and through this better services and pricing for consumers.

C.4 Debt restructuring

The reform broadens the scope of the existing exemption that permits RFBs to engage in debt-for-equity swaps to provide more flexibility to RFBs and their customers when carrying out a debt restructuring.

The current regime allows an RFB to accept equity in return for releasing a company from part or all of a debt it owes the RFB. The exemption does not account for other types of debt restructurings that do not involve the direct release of debt for equity, e.g., changes to the terms of a loan such as the tenor or interest rate. The reform will introduce greater flexibility for both RFBs and their customers.

The reforms will also permit RFBs to maintain their shareholding in a company after a debt-for-equity swap has taken place as well as provide for the fairly typical debt restructuring scenario whereby a new company ("NewCo") is formed by lenders (i.e. RFB) to facilitate a debt for equity swap (e.g. where a debt is novated to a NewCo from the existing debtor, and the participating lenders receive equity in the NewCo).

This should lead to better outcomes for both RFBs and their customers, who will have more choice when considering debt restructurings. The extent of the benefit from this reform is contingent on the commercial decisions of RFBs and their customers, and their preferences regarding debt restructuring options.

C.5 Servicing central banks

The government intends to permit NRFBs to service central banks outside the UK. The intention will be to permit NRFBs to hold the deposits of, and provide services to, any central bank outside of the UK. The proposal will enable NRFBs to provide services to these entities, who are sometimes better suited to meet the needs of central banks, so can offer improved access to the products and services required by these groups.

The proposal creates a new flexibility for NRFBs, but they will be under no obligation to engage in this sort of activity.

C.6 Inflation swaps

RFBs are currently not permitted to deal in inflation swaps (a type of derivative), which are often used in project finance transactions. The government will permit RFBs to offer inflation swaps to their customers with these reforms. This will enable banking customers to access certain types of inflation swaps from RFBs, meaning they will be able to access a wider range of products

through their existing banking relationships. Currently, RFB customers would need to access these products from other banks that are not subject to ring-fencing or are permitted to provide these products i.e., NRFBs. The duplication of banking relationships carries an additional administrative and cost burden.

The additional risk posed to RFBs by being able to provide inflation swaps will be mitigated by the existing limits in the ring-fencing regime on the position risk requirements attributable to their derivatives.

This reform introduces additional flexibility that RFBs may or may not choose to utilise, dependent on their commercial decisions.

C.7 Mortality risk and lifetime mortgages

The current exceptions for dealing as principal and incurring exposures to an RFI do not allow an RFB to hedge mortality risk. Mortality risk is the risk that a bank customer such as a mortgage holder dies sooner than expected, which curtails the forecast payments of interest on the loan and so impacts the bank's anticipated future source of revenue.

Mortality risk usually applies in the context of equity-release products such as lifetime mortgages. An equity release is a financial product which enables you to take cash out of the home you own without having to move – this is most commonly done via a lifetime mortgage. Another type of risk associated with equity release mortgages is "longevity risk", which is the possibility that a person lives longer than expected. Therefore, RFBs will also need to be able to hedge this type of risk to provide lifetime mortgages.

Allowing RFBs to hedge these types of risk will facilitate their ability to offer lifetime mortgages. In turn, this could facilitate RFBs entering the lifetime mortgage market and increasing competition. The proposal will indirectly benefit customers through the impact on choice (i.e., number of lifetime mortgage products available), pricing (i.e., lower interest rates on lifetime mortgages) and quality of product (i.e. more favourable conditions attached to mortgage products), if RFBs choose to enter the market.

This reform introduces additional flexibility that RFBs may or may not choose to utilise, dependent on their commercial decisions.

C.8 Share dealing errors

An RFB is permitted to deal in investments as agent, whereby it acts as a broker on behalf of its customers. While acting as broker, systems and processing errors can risk the failure of executing a customer's security trade, in which case an RFB may wish to step in on behalf of its client and execute the trade as principal. Additionally, a trade may fail due to an error which an RFB may want to correct by dealing as principal - purchasing the relevant security and assigning it to its client.

However, an RFB is not permitted to carry out the excluded activity of dealing in investments as principal. While this is subject to certain exemptions, these do not currently include rescuing a trade which is likely to fail due to error or has already failed.

This results in inflexibility for RFBs and poor outcomes for their customers, where it is not possible to correct inadvertent systems and processing errors which risk the failure of customer trades or cause them to fail.

The government will permit RFBs to deal in investments as principal for the purpose of correcting the failure of a securities trade which is due to error or correct trades which an RFB has made in error. This will improve the functioning of the ring-fencing regime and efficiency of intermediating trades.

C.9 Test trades

Where an RFB plans to launch a new product, service, or enhance an existing platform for customers, it may want to undertake live test trades in order to ensure a product is working as intended, as well as assess and mitigate potential operational issues associated with the product or service.

Since test trades involve dealing in investments as principal, RFBs are prevented from undertaking such tests, even for a nominal amount. This results in inflexibility for ring-fenced groups and their customers, whereby RFBs are prevented from carrying out prudent levels of due diligence with regards to the functioning of new products.

Overall, this could result in poorer outcomes for consumers, whereby new products and services offered by RFBs are prone to higher execution risk due to the inability to undertake test trades.

Therefore, the government will permit RFBs to deal in investments as principal, and incur exposures to RFIs, for the purposes of conducting test trades. The reform is a technical change that will improve the functioning of the regime.

C.10 Divestments

The regime currently does not allow an RFB to divest itself of a debenture acquired from an issuer where it relates to loans, credit, or guarantees. In such circumstances, the debenture and associated loan must be held to maturity. This has the unintended consequence of limiting an RFB's ability to divest itself of both the loan and associated debenture in a portfolio sale i.e., when they are being sold together.

The government will permit RFBs to deal in investments as principal where they are divesting i.e., selling a debenture where the loan, credit, or guarantee and the debenture are being sold together.

This reform will remove unnecessary frictions currently being caused by the regime, allowing RFBs to better manage their investments in line with their risk appetite, and respond to market conditions.

C.11 Trustee Services

RFBs are currently able to deal as principal when acting as trustee on behalf of any individual, minor, charity, or Charitable Incorporated Organisation (CIO). When dealing as principal, a counterparty may be an RFI. However, it is currently unclear whether RFBs can incur exposures to RFIs when acting as trustee for or on behalf of any minor or CIO. Therefore, the government will clarify that RFBs may incur exposures to RFIs when they act as a trustee for minors or CIO.

Additionally, the government will clarify that RFBs can act as trustee and incur RFI exposures on behalf of Scottish "nominees" which are appointed by trustees.

These reforms will remove unnecessary frictions currently being caused by the regime, without posing material risks to financial stability.

C.12 Derivatives

RFBs are not permitted to carry out the excluded activity of dealing in investments as principal, subject to certain exemptions. These exemptions include entering into currency swaps and interest rate swaps, which are offered by RFBs to enable customers to hedge their risk.

The government has identified one type of foreign exchange (FX) derivative product, "FX collars", where it will clarify the ring-fencing legislation so as to permit RFBs to provide these products. An FX collar is a forward hedging strategy that uses options and can be referred to by different names (e.g., Cap and Floor, Range Forward, Corridor).

This will allow RFBs to provide a fuller suite of derivative products to their customers, removing complexity and inefficiency for RFBs and their customers, as RFBs will no longer need to involve NRFBs to enable their customers to hedge certain types of risk.

The additional risk posed to RFBs by being able to provide FX collars will be limited by the existing limits in the ring-fencing regime on position risk requirements attributable to their derivatives.

This reform introduces additional flexibility that RFBs may, or may not, choose to utilise dependent on their commercial decisions.

Section D: Definitions and technical amendments

D.1 Structured finance vehicles (SFVs)

Currently, RFBs are prohibited from incurring an exposure to RFIs, which includes SFVs. There are exemptions for SFVs which are sponsored by an RFB ("SSFV"), where the SFV only holds assets originated by the RFB. The reforms clarify that an SFV will qualify as an SSFV where the SFV's assets were created or acquired by the RFB or its subsidiaries or by another RFB in the same group.

Additionally, the government will permit RFBs to make use of the SSFV exemptions to securitise assets where the RFB has acquired these assets from a third party as these assets must be permissible under the ring-fencing regime. This will support RFBs lending to the real economy without materially increasing risks to financial stability.

D.2 Correspondent banking definition

This reform will clarify that RFBs are permitted to incur exposures to RFIs where the exposure arises from correspondent banking arrangements which involve two or more "payment service providers". Currently the exemption only applies in situations where an exposure is to another credit institution i.e., a bank. This clarification will better reflect market practices without materially increasing risks to financial stability.

D.3 Grace period for NRFBs

The government will introduce a twelve-month grace period for NRFBs to move customers that are no longer classified as an RFI to RFBs. This will relieve the administrative and compliance burden placed on NRFBs.

D.4 Notice of Determination

Certain types of organisations are permitted to bank with NRFBs if they meet certain conditions. Where an NRFB determines that an organisation meets these requirements, it must provide that organisation with a "Notice of Determination" (NoD).

The government views the NoD requirement as redundant and will remove it. Its primary purpose was to facilitate the effective separation of banking groups at the time ring-fencing came into force. Now that this has been achieved it is no longer necessary and represents an unnecessary administrative burden. NRFBs will still be required to determine whether an organisation satisfies the conditions to be able to be banked by them.

D.5 Related undertakings

RFBs can currently hedge certain risks on behalf of itself or a member of its group or subsidiary. They however cannot do this on behalf of companies in which they and/or other certain entities in the RFB's group have a "participating interest" (i.e., 20-50% shareholding). RFBs' inability to hedge risks on behalf of participating interests creates unnecessary rigidity. The government will permit RFBs to hedge certain risks on behalf of "participating interests". This will create more flexibility without materially increasing risks to financial stability as RFBs will not be exposed to new types of risks.

D.6 Conduit vehicles

Conduit vehicles in general are used by some banks to offer secured finance to corporate customers, using companies set up by the client to hold assets acquired from the client as security for the loan. These arrangements can be economically identical to secured loans to the client, the conduit vehicle serving only to make enforcement of the security for the loan simpler in the event of default.

Certain types of conduit vehicles can be established by RFBs to originate loans. This is a source of finance for the auto sector and asset financing in particular. RFBs cannot currently acquire a financial instrument from one of its own conduit vehicles. The government will permit RFBs to acquire financial instruments creating or acknowledging indebtedness issued by one of its own conduit vehicles. This reform will improve the operation of the regime without materially increasing the risks to financial stability.

D.7 Definition of "infrastructure special purpose vehicle"

As part of the policy to remove the geographic restriction on where RFBs can operate, the government will make a number of consequential changes to remove references to the "EEA". At present, RFBs can only incur an exposure to an RFI in certain circumstances where that RFI is an "infrastructure special purpose vehicle" where the vehicle is in the UK or EEA. However, it is inconsistent to allow RFBs to establish operations outside the UK and EEA and not allow them to invest in infrastructure SPVs globally. Therefore, the government will remove the reference to UK and EEA so that RFBs can invest in infrastructure SPVs in the UK and globally. This will ensure the regime is consistent without introducing material financial stability risks.

D.8 Change in counterparty status

This reform will clarify that, where an RFB's counterparty becomes an RFI, the twelve-month grace period in article 19B EAPO only applies where there is not another applicable exemption.

D.9 Globally Systemic Important Insurers

The definition of an RFI in the ring-fencing legislation includes Global Systemically Important Insurers (G-SIIs). This means that RFBs cannot have exposures to insurers that are designated as a G-SII. The purpose of the prohibition was to limit the risks of financial contagion from the insurers to RFBs.

This reform will remove the reference to G-SIIs from the RFI definition. In practice this means that RFBs will be able to have exposures to insurers that are currently on the FSB's list.

3. What policy options have been considered, including any alternatives to regulation? Please justify preferred option

To achieve these objectives the government has considered two options:

1) **Do nothing.** Do not take forward the review's recommendations.
2) **Implement the reforms to the ring-fencing regime.** Take forward the review's recommendations that can be delivered through amendments to secondary legislation.

The regime is already in legislation; therefore, no non-regulatory options have been considered as the policy will need to be delivered through amending the existing ring-fencing statutory instruments.

Do nothing. *Do not make any changes to the regime*Ring-fencing was introduced in primary legislation through the Financial Services (Banking Reform) Act 2013 and supplemented by the ring-fencing regulations. The Financial Services (Banking Reform) Act 2013 required the then government to commission a statutory review of the regime within two years of it coming into full effect. The review's terms of reference broadly required it to assess whether the regime met its intended purpose as well as its impact on competition, international competitiveness, the provision of finance, and examine any unintended consequences.[6] The ring-fencing regime has been in force since January 2019. The review made a series of recommendations that aimed at reducing the rigidity of the ring-fencing regime and address unintended consequences, while maintaining financial stability safeguards.

Doing nothing would allow the unintended consequences and poor outcomes for banks and their customers to continue unaddressed. The review estimated that the ongoing private costs of the regime, which is £1.5bn annually (although these costs were foreseen at the time ring-fencing was introduced).[7]

Implement the reforms to the ring-fencing regime. *Take forward the review's recommendations and implement other updates that can be delivered through amendments to secondary legislation.*

As outlined above, the independent review was provided with a broad mandate to determine the impacts and functioning of the ring-fencing regime. It found a series of negative impacts and unintended consequences that could be rectified without threatening financial stability.

[6] Independent reviews of ring-fencing and proprietary trading: Terms of Reference, 2021.
[7] Ring-fencing and Proprietary Trading Independent Review Final Report, March 2022, page 82.

In its Financing Growth report, Labour committed to upholding the core purpose of the ring-fencing regime and its financial stability benefits while limiting bureaucracy for banks. The implementation of the Smarter Ring-fencing Reforms delivers on this commitment, in line with the intentions of the regime's primary legislation to keep the regime under review. The reforms result in a more flexible, less burdensome, regime and better outcomes for banks and their customers. In parallel, the reforms should also improve competition within the UK banking sector, as well as its international competitiveness, whilst maintaining appropriate financial stability safeguards. This is consistent with the government's commitment to support the UK's economic growth.

4. Please justify why the net impacts (i.e., net costs or benefits) to business will be less than £5 million a year.

The overwhelming majority of the changes in this SI do not have any **direct** impact on firms or the market. Except for the secondary threshold and removal of the NoD requirement, none of the changes will create a direct saving for firms or require a firm to make a change to the way they run their business.

By way of context on the number of businesses affected, there are currently seven banks subject to ring-fencing, some of which will become exempt, and several other banks that may choose to grow given the increase in the deposit threshold and introduction of the secondary threshold.

The reforms create optionality, with the eventual benefits resting on banks' own commercial decisions. The PRA will face some additional monitoring costs as a result of these reforms as they supervise banks' compliance with the regime as the prudential regulator. The PRA has agreed that the package of reforms will not have a direct impact of over £5 million per annum for industry or their own regulatory costs. Further detail on the five most substantial changes is set out below.

A1: Core deposit threshold: This measure does not require any firms to make changes to their business model. The increase in the deposit threshold to £35bn will not cause any firms to exit the ring-fencing regime. Any benefits or costs to firms will only materialise indirectly though the commercial decisions of banks and the profitability of this will depend on wider macro-economic and market factors which make the indirect costs difficult to calculate.

A2: Secondary threshold: It is anticipated that two firms will exit the ring-fencing regime as a result of this measure and will experience a direct cost-savings as a result. In response to the September 2023 consultation, one firm provided an estimate on the potential direct savings to their business. Assuming that both firms have similar costs, this would result in a direct saving of approximately £2m per annum in total. No other firms will be directly impacted by the change.

B1: Geographical restrictions: This measure does not impose new requirements on firms but introduces flexibility to operate in new jurisdictions globally. Any changes in group structures will stem from the commercial decisions of firms.

C1: Equity investments: This measure will have little to no direct costs to firms as it introduces flexibility for RFBs to undertake new types of activity. The government does expect that some RFBs will utilise this new exemption, which will result in indirect benefits as discussed in section C.

C2: Exposures to certain small financial institutions: This measure will have direct benefit for RFBs as it will reduce the compliance and administrative burden placed on RFBs which stem from breaches. It is not possible to assess the direct cost savings for RFBs of no longer having to report breaches to the PRA as it is not possible to forecast future breaches of the ring-fencing regime.

Other benefits, stemming from increased RFI access to banking services, are indirect and will be dependent on the future commercial decisions of individual RFBs.

Given the above, in view of A2 (Secondary threshold), the best broad estimate of the **direct** impacts of these measures is a saving to business of £2m per year.

5. Please confirm whether your measure could be subject to call-in by BRE (Better Regulation Executive) under the following criteria. If yes, please provide a justification of why a full impact assessment is not appropriate:

a) **Significant distributional impacts (such as significant transfers between different businesses or sectors)**
No

b) **Disproportionate burdens on micro, small, and medium businesses (below 500 employees).**
No

c) **Significant gross effects despite small net impacts**
No

d) **Significant wider social, environmental, financial, or economic impacts**
No

e) **Significant novel or contentious elements**
No

Sign-off for de minimis assessment: SCS

I have read the de minimis assessment and I am satisfied that it represents a fair and proportionate assessment of the impact of the measure.

SCS of Financial Stability Strategy and Analysis

Signed: ***James Fairburn*** Date: 01/10/2024

SCS of Better Regulation Unit

Signed: ***Jonathan Edwards*** Date: 01/10/2024

Sign-off for de minimis assessment: Minister

I have read the de minimis assessment and I am satisfied that it represents a fair and proportionate assessment of the impact of the measure.

(Name, Ministerial role)

Signed: ***Tulip Siddiq, Economic Secretary to the Treasury*** Date: 16/10/2024