Banking Bill:

Impact Assessment

October 2008

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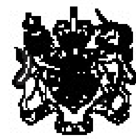 HM TREASURY

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1

BANKING BILL - IMPACT ASSESSMENT

Summary: Intervention & Options

Department /Agency: HM Treasury	Title: Impact Assessment of the Banking Bill	
Stage: Implementation stage	Version: BILL/01	Date: 7 October 2008

Related Publications: Discussion Paper, Banking reform - protecting depositors; Consultation Documents: Financial stability and depositor protection: 1) Strengthening the framework (Jan 08); 2) Further Consultation (July 08) and Special Resolution Regime (July 08)

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Contact for enquiries: banking.reform@hm-treasury.gov.uk **Telephone:**

What is the problem under consideration? Why is government intervention necessary?
Banks are an important part of a well-functioning economy. Banking failures and financial instability may impose severe costs on the economy. To guard against this, banks are regulated and subject to supervision by the Authorities. Events in the financial sector since mid-2007 have highlighted a number of areas for improvement to the UK regime for financial stability and protecting depositors.

What are the policy objectives and the intended effects?
The Banking Bill aims to achieve the following objectives:
- reducing the likelihood of individual banks facing difficulties;
- reducing the impact if, nevertheless, a bank gets into difficulties;
- providing effective compensation arrangements in which consumers have confidence; and
- strengthening the Bank of England and ensuring effective coordinated actions by the Authorities

What policy options have been considered? Please justify any preferred option.
The measures included in the Bill are the result of an extensive process of consultation and a comprehensive effort by the Authorities to develop effective policies to ensure the huge benefits to the economy of continued financial stability at the smallest possible cost to the economy. An example of this is the decision to delay any pre-funding of the FSCS until such a time as it were considered appropriate.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?
The effectiveness of the legislation will be subject to ongoing review

Ministerial Sign-off For final proposal/implementation 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 policy and that the benefits justify the costs.

Signed by the responsible Minister:

.... Date: 6 October 2008

Summary: Intervention & Options

Policy Option: Banking reform proposals	**Description:** See the evidence base for a detailed analysis of the costs and benefits of each proposal

ANNUAL COSTS		Description and scale of **key monetised costs**	
One-off (Transition)	**Yrs**	One-off costs relate to streamlining the FSCS claims process; ongoing costs reflect costs to the FSCS of processing information. The Bill includes a power to allow the introduction of pre-funding into the FSCS. If pre-funding were introduced then costs to deposit-takers would significantly increase. (However, there would be lower costs at a later date if a bank failed. So this is a purely contingent cost.) To give an indicative scale, the annual and ongoing costs to the FSCS levy payers could be in the range of £118 million to £236 million per year over twenty years.. Further details on pre-funding are set out in the evidence base.	
£ 1.5m – 3.0m	1		
Average Annual Cost (excluding one-off)		**Total Cost** (PV)	**£ 2.2m – 4.5m**
£ 0.0m – 0.1m			

Other **key non-monetised costs** Many costs are non-monetised. This is because they will only be incurred in particular cases of financial instability, a bank failure, or a bank getting into difficulties. Thus they are contingent on unpredictable and infrequent events (such as financial crises or the failure of individual firms) or conditional on the Authorities' response to them.

ANNUAL BENEFITS		Description and scale of **key monetised benefits**	
One-off	**Yrs**	Ongoing benefits solely relate to Scottish cheques.	
£ 0.0m	1		
Average Annual Benefit (excluding one-off)			
£ 0.3m – 0.4m		**Total Benefit** (PV)	**£ 3.6m – 5.1m**

Other **key non-monetised benefits** There are significant non-monetised benefits: these are derived from reducing the likelihood and impact of financial instability and bank failure. Thus they are contingent on unpredictable and infrequent events. They will vary by firm, the financial climate, the Authorities' response etc.

Key Assumptions/Sensitivities/Risks The real discount rate used is 3.5%

Price Base Year 2007	Time Period Years 20	**Net Benefit Range** (NPV) **£ - 0.8m**	**NET BENEFIT** (NPV Best estimate) **£ 2.8m**

What is the geographic coverage of the policy/option?	UK
On what date will the policy be implemented?	Varies by proposal
Which organisation(s) will enforce the policy?	Varies by proposal
What is the total annual cost of enforcement for these organisations?	£
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	£ Negligible	Decrease of	£ Negligible	**Net Impact**	**£**

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

Specific Impact Tests: Checklist

Type of testing undertaken	*Results in Evidence Base?*	*Results annexed?*
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	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

INTRODUCTION

Assessing the impact of the Bill

1.1 This implementation stage impact assessment sets out the case for Government intervention, the proposals that are included in the Banking Bill, and an analysis of the benefits, costs and likely impact of the proposed reforms.

1.2 This implementation stage impact assessment follows from the consultation stage impact assessments published alongside the January and July 2008 consultation documents. The analysis has been updated to reflect changes of policy and to incorporate additional evidence.

Stakeholder views

1.3 In response to the most recent consultation documents Financial Stability and Depositor Protection: Further Consultation and Financial Stability and Depositor Protection : Special Resolution Regime (SRR) the Government received a combined total of 78 responses. Contributions were received from the major interested representative bodies; including the British Bankers' Association (BBA), the Building Societies Association (BSA), the London Investment Banking Association (LIBA) and the Investment Managers Association (IMA) amongst many others as well as a number of individual banks. We also received responses from a wide range of other organisations, from Age Concern to the Financial Ombudsman's Service. There was considerable input from law firms, experts in insolvency and payment systems. In addition, 20 academics and individual consumers responded to the consultation with their comments.

1.4 This impact assessment is published alongside the Banking Bill on its introduction to Parliament. It contains a more detailed analysis of the likely benefits, costs, and impact of the reforms, taking into account policy development occurring in the light of previous consultations.

Scope

1.5 Only the reform proposals to be included in the Banking Bill are included in this impact assessment. FSA consultation on those measures of the wider reform package that do not require primary legislation and are instead implemented through FSA rules, will include, as required by FSMA, a detailed cost-benefit analysis. As such, these reforms are not analysed in this document.

Structureof this implementation stage impact assessment

Relationship with the consultation document and the Banking Bill

1.6 The impact analysis for each proposal is set out in the final section of this impact assessment in the order in which they appeared in the July consultation document 'Financial stability and depositor protection: further consultation' The numeric totals in the template reflect the sum of the benefits and costs for each policy. In line with impact assessment guidance, the template only contains benefits and costs associated with the Banking Bill.

Terminology

1.7 Benefits and costs are split in two ways: firstly, between direct and indirect; and secondly, by quantifiable and non-quantifiable.

Direct versus indirect – Direct benefits and costs are those that will be incurred regardless of circumstances of financial instability or bank failure. These are distinct from indirect benefits and costs which arise only in these instances. Thus direct benefits and costs are non-contingent; indirect ones are contingent.

Quantifiable versus unquantifiable – Quantifiable benefits and costs are those for which the Authorities are currently in a position to estimate. These are clearly set out in each part of the impact assessment and summed to produce the totals presented in the impact assessment template. However, many benefits and costs are unquantifiable. In these cases indications are made to their scale, and the Authorities will continue to attempt to estimate them, where feasible, over the course of the consultation period.

Structure 1.8 This impact assessment annex is structured as follows:

1. the case for intervention and regulation by the Tripartite Authorities;
2. costs of financial instability and bank failure;
3. sectors and groups affected;
4. small firms impact assessment; and
5. analysis of proposals.

CASE FOR INTERVENTION AND REGULATION IN THE FINANCIAL SECTOR AND JUSTIFICATION FOR INTERVENTION

Importance of banks 1.9 The financial sector plays a vital role in the global economy. It intermediates between savers and borrowers through the investment chain, allowing savings to be allocated to worthwhile investment; helps firms and individuals manage risk, through insurance and other financial products; and allows them to store, access and move wealth, through deposit accounts and payment systems. For this reason the stability of the financial sector is paramount.

1.10 This is especially the case because of the interrelationships between firms in the sector. The banking sector is unusually vulnerable to losses of confidence through the risk of contagion. As banks have substantial lending and other exposures to each other and because of the informational asymmetry between banks and their customers, many bank investors and depositors could infer problems for the sector as a whole from bad news at a few banks.

1.11 Banks, building societies and other deposit-taking firms (for simplicity referred to as ‘banks’ unless otherwise specified) provide the bulk of the immediately available liquidity for UK households and non-financial business. They are key participants in the payment systems and are a key source of finance for households and businesses, especially those that do not have access to capital markets. Banks can have these roles because they are fundamentally different from industrial and commercial companies: by taking deposits their liabilities are “money” and so are essential parts of a well-functioning modern economy. Banks liabilities are liquid only because (except in the case of a bank run) banks have the ability to pool a large number of independently distributed risks. Crucially, banks’ role in maturity transformation and their associated dependence on access to liquidity make them vulnerable to losses of depositor confidence, when these risks cease to be independently distributed and become highly correlated, which may lead to bank runs and wider systemic consequences.

Cost of failure 1.12 Bank failures are therefore capable of undermining financial stability, especially if they lead to a loss of depositor confidence in other banks. Given this, any failure of a bank of sufficient size is likely to have significant economic costs, which will fall on the customers of the particular bank and also on the wider economy. These are discussed in more detail in the section, ‘Costs of financial instability and bank failure’.

1.13 Major banking failures are historically rare in the UK. However, the consequences of banking failure (and therefore banking crises) are likely to be extremely serious. Box A.1 discusses the aggregate costs of financial crises that have previously occurred in other countries. Furthermore, as consolidation in the financial sector has increased, and may continue to increase, so the impact that a failure of a bank would potentially have increases too.[1]

Rationale for regulation

1.14 To guard against the risk of financial instability, banks are regulated and subject to supervision by regulatory authorities – in the UK by the FSA. In normal conditions there should be little conflict between managing the business to maximise shareholder value and ensuring the security of depositors' money. But once insolvency or major liquidity problems threaten, shareholders' interests may well diverge from those of depositors and of the wider public interest in financial stability. Shareholders' incentives may mean a willingness to take greater risks, whereas the maintenance of depositor confidence and avoidance of insolvency would be best provided by risk-minimising strategies (which may reduce growth of business) and the injection of new equity, diluting existing shareholders' rights. The bank's management (or shareholders) may simply take a different – more optimistic – view of the bank's future prospects and the risks its activities impose on the financial system than the Authorities. There are negative externalities attached to this as the actions of a bank's management may go on to affect a wider range of stakeholders through the various transmission mechanisms of the financial sector. These issues give grounds for intervention and regulation by the Tripartite Authorities.

Responding to market failure

1.15 The problems faced by Northern Rock plc in 2007 demonstrated both the importance of consumer confidence to ensuring financial stability, and that then the existing arrangements for dealing with banks in distress did not adequately uphold that confidence in certain circumstances, thus exacerbating the threat of financial instability. Moreover, that framework may not adequately deal with existing market problems relating to the liquidity regime and the compensation scheme, in particular:

- consumers do not have sufficient awareness of, or confidence in, the current compensation arrangements;
- the powers available to the Authorities to reduce the likelihood or impact of a bank failing need to be updated and expanded;
- the existing regime for resolving failing banks through the application of general corporate insolvency law is inadequate; and
- changes to the UK regime need to take place in the context of changing international markets and the need for greater international coordination.

1.16 In order to rectify the issues outlined above, the Authorities proposed a package of reforms in three consultation documents published in January and July 2008. The measures in this Banking Bill are the result of an extensive process of consultation and scrutiny by industry, experts and other interested groups.

1.17 The Authorities believe that the policy measures contained in this Bill will successfully take steps towards solving the market failures discussed above. Moreover, the Authorities have assessed that the package of proposals is a proportionate response to the events of 2007 and 2008.

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[1] Group of Ten, Report on Consolidation in the Financial Sector, 25 January 2001

COSTS OF FINANCIAL INSTABILITY AND BANK FAILURE

1.18 The proposals for reform address the difficulties with the current UK regime and the risks they pose to financial stability and consumer confidence. In doing this, they aim to reduce the costs of a future banking crisis by taking steps to reduce both the likelihood and impact of such an event. This section sets out the costs associated with financial instability and bank failure under the current framework and discusses their implications for the economy and financial stability more broadly.

1.19 Costs are broken down between:

- depositors;
- borrowers;
- the Exchequer; and
- the economy as a whole.

Costs to depositors

1.20 The failure of a single bank can impose costs on the economy through a number of channels and even if the disruptive effects are not large enough to make a significant impact on output at an aggregate level, they can cause significant disruption to individual consumers. These effects may be more pronounced if the bank has a significant geographic or sectoral concentration of business.

1.21 In the UK, approximately 90 per cent of the population have a current account.[2] The five largest banking groups provide a considerable proportion of current account facilities. Basic banking functions, particularly the ability to make and receive electronic payments, have become extremely important to everyday life in the UK: over 90[3] per cent of wages are paid directly into bank accounts, approximately 98[4] per cent of benefits are paid into a bank account (or Post Office card account) and over 75[5] per cent of adults in the UK have at least one Direct Debit. A bank failure of any medium or large firm is therefore likely to have widespread social and economic implications for a large numbers of individuals, households and businesses.

1.22 Under current arrangements, if a bank were to fail, depositors would suffer through loss of:

- liquidity, due to the nature of sight accounts (current accounts and instant access savings accounts) as immediate sources of cash;
- of access to payments systems, due to the transactional role of current accounts; and
- wealth, where current and savings accounts (including notice accounts) are used as a form of investment (to the extent that the depositor's balance exceeds the FSCS compensation limit and the depositor does not recover these additional funds through the insolvency process).

2 Family Resources Survey, 2005-06

3 Bacs, < http://www.bacs.co.uk/BACS/Consumers/Bacs+Direct+Credit/>

4 Department for Work and Pensions

5 Bacs, < http://www.bacs.co.uk/BACS/Consumers/Direct+Debit/>

Loss of liquidity

1.23 Economic literature and experience of past failures document that a major consequence of a retail bank failure is the opportunity cost to depositors from losing access to their deposits (that is, the loss of liquidity). Loss of liquidity occurs if depositors at the failed bank are unable to access any of their funds after failure until the proceeds from the sale of the bank or its assets are distributed: in essence current accounts become long-term savings and there are further liquidity losses when credit lines cannot be relied upon or drawn down by borrowers to meet business needs (such as paying their bills and loans). For anything other than a small bank failure, enough consumers will be affected for the loss of liquidity to be rapidly and widely publicised. To the extent that this undermined confidence in the banking system more generally, this could, in turn, increase the probability of a run developing at other, healthy banks.

1.24 Customers would face a loss of liquidity between the failure of the bank and the point at which they receive compensation from the FSCS and recoveries from the estate of the failed firm. Under current arrangements, this could last several months. If current and instant access savings accounts are a large proportion of total deposits in the economy (as in the case of the UK), the resulting illiquidity may also have macroeconomic consequences.[6]

1.25 If a bank involved in cash handling and distribution were to fail, then there could be some disruption to cash circulation, as banknote-sorting capacity could be reduced and distribution of cash to ATMs and banks and firms around the country would be disrupted. There may have to be some substitution by firms and individuals to other methods of payments (for example, debit card transactions or cheques).

Loss of access to payment systems

1.26 Payment systems are important for the functioning of the financial markets and the economy, therefore robust and effective payment systems are important for almost every economic transaction that takes place. The inter-linkages between payment systems, banks and other financial intermediaries means that problems have the potential to spread through the financial system, which can ultimately affect business and consumers.

Loss of wealth

1.27 Should a bank fail and the FSCS pays out compensation, a small portion (data suggests that the current compensation limit of £35,000 covers approximately 97 per cent of all UK depositors) of depositors will not be fully covered by the FSCS. If the total funds invested in a single firm by a depositor are above the FSCS compensation limit, then they may lose some or all of their deposits above the compensation limit. However, this is not necessarily wholly a welfare cost. If depositors are fully informed about the compensation limit, then the investment decision may be viewed as the outcome of a maximising portfolio choice problem (in which the investor has invested above the compensation limit in order to trade-off greater risk for greater expected return). Thus it may be optimal to accept some of the risk. However, this full information assumption is clearly imperfect and so, in reality, such a loss of wealth would impose a welfare cost (proportionate to the amount lost and their total wealth) for this small group of individuals.

Costs to borrowers

1.28 The size of the costs associated with bank failure will vary from borrower to borrower but are likely to be highest where firms (especially) or individuals are unable to easily signal their creditworthiness as borrowers to another lender. In this

[6] See, for example, Anari, Kolari & Mason, "Bank Asset Liquidation and the Propagation of the Great Depression", Journal of Money, Credit, and Banking, August 2005.

case, the long-term relationship between the borrower and their bank has value as it enables the bank to evaluate the borrower more effectively.

1.29 This asymmetric information problem is most commonly associated with small firms, for whom the costs of signalling their credit-worthiness through the production of credible public information (for example, agency ratings or detailed financial statements) are too high, or firms in specialised industries where lending decisions require detailed knowledge of individual projects.

1.30 Even if firms are able to find another lender, they may face higher borrowing costs (or credit rationing) if lenders are less able to assess firms' soundness, and may therefore require higher returns in recompense. Information gathered by the incumbent bank allows it to price risks more efficiently and this mitigates the problem of adverse selection (that is, 'safe' borrowers are charged lower rates than 'riskier' borrowers). The less-informed outside lender pools all borrowers together, which distorts investment decisions (safe borrowers are overcharged and under-invest; risky borrowers are undercharged and over-invest). Switching costs may be higher if other banks believe that the failed bank's loan book was of poor quality, as this may impact adversely on their view of the soundness of the failed bank's customers.[7]

Costs to the Exchequer

1.31 The government may incur costs if it chooses to intervene in an attempt to resolve or alleviate the crisis. Unless these costs are offset by proceeds from the resolution (for example the sale of a state-owned bank) or recharged to another party (for example, FSCS levy payers), this loss will, ultimately, be borne by the taxpayer. Fiscal outlay may arise through a number of different means such as:

- liquidity support, for example a central bank providing liquidity support;
- recapitalisation of failing banks;
- liability guarantees of wholesale and consumer liabilities (technically a contingent cost unless the guarantees are 'called');
- other interventions, for example bulk-buying of bad debts.

1.32 While these are likely to be short-term one-off costs, they may alter perceptions of how governments will react to crises in the future. If the public policy response does not contain a suitable punishment for those responsible, then the financial sector may realise that it has less of an incentive to properly manage risk. This is the problem of moral hazard. However, there will be some situations in which the costs to the economy of not intervening are significantly greater than the fiscal costs of taking action, hence intervention may be an optimal response.

Costs to the economy

Financial sector

1.33 The cost of funding the FSCS is covered by the UK financial sector in the event that the eventual recoveries from a failed bank were insufficient to cover the payment of insured depositors. The UK has a limited history of bank failure but the experience of the FDIC (Federal Deposit Insurance Corporation) in the US shows that the rough cost

[7] See for example, Slovin., Sushka, & Polonchek ("The Value of Bank Durability: Borrowers as Bank Stakeholders" Journal of Finance , 1993) and Kang & Stulz ("Do banking shocks affect borrowing firm performance?" Journal of Business, 2000)

(to the FDIC) of resolving failing financial firms was around 14 per cent of the total deposits of firms that failed during the period 1990-2007. However, given the highly concentrated nature of the UK banking system, this US analogy may underestimate the average cost of a bank failure in the UK.

1.34 Financial market participants are likely to face disruption if the failed bank acted as a counterparty, correspondent or market maker for them. Asset 'firesales' by the distressed firm would add to this disruption.

1.35 Disorderly bank failures might therefore be expected to impact adversely on London's standing as a financial centre through two channels: firstly, through a loss of confidence by depositors; and secondly, through a loss of confidence by financial market participants. These costs are likely to be a mixture of one-off and ongoing.

Wider economy

1.36 All of the types of cost discussed above – costs to depositors, borrowers, the Exchequer and the financial sector – will feed through in some form to the wider economy. This will be through a range of transmission mechanisms. In general, the academic literature on these costs is clear that in the event of a systemic banking crisis there may be a significant impact on the income and wealth of the economy as a whole. Box A.1 provides a brief summary of this literature.

Box A.1: Aggregate costs of financial crises

The previous section describes the effects of the failure of an individual bank on its customers. However, if multiple banks, representing a significant part of the banking sector, fail or become severely weakened at the same time, there will be additional effects on the economy.

If the banking sector lacks capital, and is unable or unwilling to raise more, it may choose to cut back on lending to firms and households in order to rebuild capital ratios. Similar cutbacks may follow if deposits and other lending to banks are withdrawn due to a loss of confidence in the banking system. Such a loss of confidence is also likely to make it harder for banks to raise additional capital, and may affect even banks with little exposure to the original cause of the crisis if they are unable to prove their soundness to investors.

These reductions in bank lending in turn may affect the economy by limiting the ability of firms and households to make new investments, or smooth shocks to their income and consumption.

Alternatively, capital constrained banks may seek to avoid recognising losses; for instance ensuring that troubled borrowers can continue to service loans by extending them new credit. If such 'evergreening', or similar practices, becomes widespread it can lead to an inefficient allocation of investment in the economy.

The effect on output of these and other costs can be very large. One estimate[a] puts the average cumulative output loss (relative to trend) in a sample of 47 banking crises at 15-20% of GDP (depending on the measurement method), and found that crises in developed countries are as severe as those in developing countries. Crises can also be long-lasting: in the same study the average length of crises in developed countries was 5.5 years.

These costs are not shared equally across the economy. There is evidence[b] that industrial sectors which have more small firms, or which are more dependent on external financing, are more severely affected by crises. One study[c] finds that the bulk of the fall in output in the first two years of a crisis is accounted for by a fall in investment, although consumption and inventories also fall, offset by a rise in net exports.

[a] "Corporate financial structure and financial stability"; E. P. Davis and M.R. Stone; Journal of Financial Stability 1 (2004) pp65-91

[b] "The Real Effect of Banking Crises"; G. Dell'Arriccia, E. Detragiache, R.Rajan; IMF Working Paper 05/63

[c] "Corporate financial structure and financial stability"; E. P. Davis and M.R. Stone; Journal of Financial Stability 1 (2004) pp65-91

SECTORS AND GROUPS AFFECTED

1.37 The proposals presented in the consultation document will affect (either directly or indirectly) the following groups:

- Depositors – over 90 per cent of households in the UK have some form of deposit account.[8] The size of the UK protected deposits market is estimated at £950 billion.[9]

- Banks – There are 156 banks incorporated in the UK.[10]

- Building societies – There are 59 building societies in the UK.[11]

[8] Family Resources Survey 2005-06

[9] FSA data.

[10] FSA, Annual Report 2007/08

[11] Building Societies Association, <http://www.bsa.org.uk/keystats/index.htm>

Credit unions – There are 559 registered credit unions in the UK.[12]

Authorities – The Treasury, the Bank of England and the FSA, and in some instances, the FSCS.

The wider financial industry

Non-financial industry – Non-bank stakeholders may be indirectly impacted, for instance through changes in bank behaviour, lending or investment policy. [DN – check figures]

IMPACT ON SMALL FIRMS

1.38 Previous impact assessments considered small firms in two ways:

1. As a consumer of banking services, a depositor or a borrower; and
2. As a provider of banking services, a bank. It is likely that for these small firms, the proposals relating to compensation in Chapter 5 will be the most important.

Stakeholder views

1.39 The January impact assessment asked respondents whether they thought small businesses would be affected by the proposals in a different way to other consumers.

There were no strong views expressed on this question. Of those who did respond, most did not believe that small business stood to be disproportionately adversely affected by any of the proposals.

Small firms as consumers

1.40 None of the proposals treat small firms differently to other consumers. In particular, under both the current and proposed rules, the FSCS would compensate small businesses for lost deposits if their bank became insolvent, up to the compensation limit.

Small firms as providers

1.41 Some banks, particularly the smaller credit unions, may be classified as small firms. As such, they may be subject to some of the regulatory measures proposed in this impact assessment.

1.42 In drafting rules, the FSA has a duty to pay due regard to ensuring that regulation is proportionate and that the measures considered do not disproportionately affect small firms. In some circumstances, it may be desirable to exempt specific types of firms from specific requirements.

ANALYSIS OF POLICY OPTIONS

1.43 The following section sets out an analysis of each of the policy options proposed by the Authorities.

REDUCING THE LIKELIHOOD OF A BANK FAILING

1.44 This section discusses legislative proposals included in chapter three of the July consultation document 'Financial stability and depositor protection: further consultation' and Parts five and seven of the Banking Bill.

[12] FSA, 2006 Annual Statistics, February 2007

Collecting and Sharing Information – Financial Stability

Description

1.45 The Banking Bill will enable the FSA to obtain information relating specifically to financial stability and to provide the Bank of England with access to this information. Once enacted the Bill will facilitate a better exchange of information amongst the Tripartite Authorities in fulfilment of their responsibilities with regard to financial stability.

1.46 Currently, in the context of the Tripartite Memorandum of Understanding, it is principally the FSA that gathers information on the firms that it authorises and supervises, using its information-gathering powers under FSMA. However, the FSA is not permitted to collect information that the Bank of England or the Treasury may require but which the FSA itself does not require.

1.47 To ensure each of the Authorities is able to carry out its role fully, the Government is legislating to ensure there is no statutory impediment to the FSA obtaining any information that the other Authorities require as they require it. The changes will ensure that the definition of the functions for which the FSA has power to collect data under FSMA would, in addition, allow it to collect data for the Bank of England's proposed financial stability statutory objective.

Benefits

1.48 Each of the Authorities has a key role in maintaining financial stability. Currently, the FSA's scope to collect information is limited to doing so for the Authority's functions as outlined in FSMA. The Bank of England's power to collect information is limited to its monetary policy role. The proposed changes will ensure that the FSA has the power to collect data needed to fulfil the Bank of England's financial stability purpose – which includes both 'normal time' and 'in-crisis' contributions to maintaining financial stability. Improving information sharing is likely to enhance the response of the Authorities to issues relating to financial stability.

Quantification: It is not feasible to quantify these benefits. However, the 'Costs of financial instability and bank failure' section sets out the benefits of preventing financial instability.

Costs

1.49 Costs for supervised firms and the Authorities will depend on any increases in information requirements. But, since the FSA will remain the only Authority empowered to collect information from regulated firms directly, the burden of any additional reporting is likely to be slight. The FSA and Bank of England also intend to codify practices in a Protocol which will ensure arrangements to collect and share information are as efficient as possible. Further, the Authorities do not envisage that significant additional information (surplus to what is already provided to the FSA) will be required to be supplied to the Bank of England or the Treasury in times of financial stability.

Quantification: Contingent on any increases in ongoing data requirements. Likely to be a minimal burden except in rare periods of serious financial instability, where the firm in question is a source of concern to the Authorities.

Groups affected

1.50 Directly: the Authorities and supervised firms where additional reporting requirements are put in place.

Competition assessment

1.51 This measure should not have a significant impact on competition.

Risks 1.52 There is a risk that this proposal may increase the amount of information requested by the FSA from the firms it supervises, which may have cost implications for both firms and the Authorities requesting the information. To mitigate against this risk, as noted above the Authorities will codify arrangements to ensure the efficient collection of information in an agreement.

Statutory Immunity of the Bank of England

Description 1.53 The Banking Bill will provide the Bank of England with statutory immunity from liabilities in damages arising from acts or omissions in carrying out its responsibilities in relation to financial stability and other central bank functions.

1.54 Currently, both the FSA and FSCS have a statutory immunity in discharging their responsibilities. However, the Bank of England does not. The risk of litigation may therefore make it difficult for the Bank of England to discharge its responsibilities effectively and in full.

1.55 The Government is therefore providing that the Bank of England shall have statutory immunity from liability in damages arising from carrying out its responsibilities in relation to financial stability and other central bank functions.

Benefits 1.56 This proposal ensures that the actions taken by the Bank of England in discharging its responsibilities in relation to financial stability and other central bank functions are protected from the threat of legal action seeking damages from the bank. Such litigation may have an adverse operational impact as it may restrict the Bank of England's actions in a time of financial instability. Removing these constraints will allow the Bank of England greater flexibility in its actions, and so may reduce the costs of financial instability and bank failure.

Quantification: It is not feasible to quantify these benefits. However, the 'Costs of financial instability and bank failure' section sets out the benefits of preserving financial stability.

Costs 1.57 There are no significant ongoing or one-off direct costs associated with this measure.

Quantification: Negligible.

Groups affected 1.58 Directly: the Bank of England. Indirectly: any firms that were affected by Bank of England actions that would not otherwise have occurred without statutory immunity.

In addition, any party that would otherwise have taken legal action against the Bank of England.

Competition assessment 1.59 This proposal should not have a significant impact on competition.

Risks 1.60 To mitigate against the risks associated with this power, the Act does not extend the immunity to the Bank of England's usual or contractual relationships with third parties (for example, in relation to market counterparties and other commercial agreements), and excludes instances where the Bank of England acted in bad faith or involved breaches of the Human Rights Act, placing the Bank of England on a level of parity with the FSA and FSCS.

Bank of England Weekly Return

Description 1.61 The proposed Banking Act will remove the requirement for the Bank of England to issue a weekly return.

1.62 At present the Bank of England must produce a weekly return of accounts, as laid out in the Bank Charter Act, 1844. The Bank of England shall subsequently have the power to determine whether, and in what form, it wishes to publish any weekly return.

Benefits 1.63 In the event that the Bank of England has given liquidity support to firms, there is benefit to maintaining some degree of confidentiality in order to stabilise market sentiment. One of the ways in which information of any such assistance could potentially be determined is through a study of the weekly return. The Government has therefore provided that the Bank of England shall no longer be required by law to produce such a return.

Quantification: It is not feasible to quantify these benefits. However, the 'Costs of financial instability and bank failure' section sets out the benefits of preserving financial stability.

Costs 1.64 These are expected to be negligible, since other sources of information regarding the Bank of England's activities are available.

Quantification: Negligible.

Groups affected 1.65 Directly: The Bank of England, which shall no longer be bound by this particular requirement. Any analysts currently utilising the weekly return could also be affected should the Bank of England choose to exercise its right to cease publication of the return.

Competition assessment 1.66 This proposal should not have a significant impact on competition.

Risks 1.67 There are no significant risks associated with this measure.

Liquidity Support for Building Societies

Description 1.68 The Banking Act will ensure that floating charges may be granted by building societies in relation to the provision of liquidity support by central banks.

1.69 Currently, legislation prevents a building society from offering the Bank of England effective security over what may be its only available collateral (typically mortgage loans and related cash collection accounts) in return for liquidity assistance.

1.70 The Government is modifying the provisions of the Building Societies Act, 1986, in such a way as that HM Treasury shall have powers to allow building societies to grant floating charges to the Bank of England or other central banks of the European Economic Area in relation to the provision of liquidity support. These charges will also be exempted from registration at Companies House, as per "Registration of Charges" below.

Benefits 1.71 Liquidity assistance is an important tool available to the Authorities to assist a firm in difficulties. This change allows the Bank of England to grant liquidity support to a building society in exchange for security in the form of a floating charge, and in a timely and effective manner. As such, it should improve both depositor confidence and

market confidence. It seeks to protect taxpayers' interests by liquidity assistance being secured by an effective charge against assets.

Quantification: It is not feasible to quantify these benefits. However, the 'Costs of financial instability and bank failure' section sets out the benefits of preventing a bank failure.

Costs 1.72 There are no significant ongoing or one-off direct costs associated with this measure.

Quantification: Negligible.

Groups affected 1.73 Directly: building society receiving liquidity from the Bank of England. Indirectly: consumers of the building society, who may benefit if this action prevents a failure. Other creditors of the building society who may similarly benefit.

Competition assessment 1.74 This measure should have a positive impact on competition, as it levels the playing field between banks and building societies for receiving liquidity assistance from the Bank of England.

Risks 1.75 There is a risk that this proposal could be considered adversely to affect the position of building society members (though this should be limited to the extent that the removal of these provisions is limited to security or borrowing in favour of the Bank of England). It could also affect unsecured creditors.

Registration of Charges

Description 1.76 The Banking Bill provides that any charges granted to a central bank in connection with its functions as a central bank shall be exempt from registration at Companies House.

1.77 Under the Companies Act, 2006, certain forms of charge or charges over certain categories of asset (which may be applicable where the Bank of England provides a company with liquidity support against relevant collateral) must be registered within 21 days of the creation of the charge concerned. Companies are also required to maintain a register of all charges created by them at their registered office and to provide copies of this on request.

1.78 Removing the requirement on banks to register charges over certain assets would mean that liquidity assistance could not be identified from their own register or the register at Companies House.

Benefits 1.79 In the event that the Bank of England has given liquidity assistance, non-disclosure (through means of removing the requirements for banks relating to the registration of charges granted to the Bank of England as a central bank) could help preserve market and consumer confidence and allow stability to return to a bank. The disclosure of liquidity assistance and the negative connotations attached to receiving it from the Bank of England may harm consumer confidence and cause the type of problems that the lending operation was intended to prevent.

Quantification: It is not feasible to quantify these benefits. However, the 'Costs of financial instability and bank failure' section sets out the benefits of preventing financial instability.

Costs 1.80 Exempting charges that are granted to a central bank in connection with its central bank functions may impose a cost on shareholders and creditors of a borrower who wish to investigate the extent to which the borrower has created charges over its assets. The Companies House register provides information – albeit in general terms – relating to when the charge was created, which persons are entitled to the benefit of the charge, the amount that has been secured and the property that has been charged. This information is sought routinely in connection with legal transactions (such as mergers and acquisitions, leases, property sales, etc.). However, fixed charges over most types of assets (other than land) are not required to be registered at Companies House nor is it common practice for creditors to investigate the company's own register. Title transfer collateral arrangements, which are increasingly the favoured form of taking collateral for many financial institutions, also fall outside any registration regime. . Furthermore, the Financial Collateral Arrangements (No. 2) Regulations 2003 already provide an exception to the registration requirements in relation to financial collateral arrangements. Accordingly, creditors wishing to obtain a fuller picture of a borrower's secured assets are already required to make enquiries to the borrower directly.

Quantification: For the reasons outlined above, the Authorities do not expect these costs to be material.

Groups affected 1.81 Directly: any bank receiving liquidity support from the Bank of England that would have been required to register a charge against its assets. Indirectly: depositors and other creditors of the bank, who may benefit if such liquidity support prevents a failure. It would also have a potential adverse effect on future creditors of the bank, who would be extending credit to the bank, unaware of the liquidity support.

1.82 This measure should not have a direct effect on competition. However, there may be an indirect benefit to any bank receiving liquidity support from the Bank of England not to register charges against its assets (and hence reveal that liquidity support has been given). However, the decision of whether to delay disclosure will normally be taken by the Authorities where it is judged that in doing so adverse impacts on the rest of the financial sector are minimised.

Risks 1.83 Any removal of the current registration requirement delays the discovery by the financial sector that a firm has received liquidity support from the Bank of England. This reduces transparency.

Oversight of Payment Systems

Description 1.84 The Banking Bill formalises the Bank of England's role in the oversight of payment systems to ensure the robustness of payment systems, where, if a disruption in the operation of the system were to our, it would be likely to lead to systemic or system-wide consequences.

1.85 The Bank of England currently undertakes oversight of payment systems on a non-statutory basis focusing on promoting the robustness and resilience of key UK payment systems, while the FSA has statutory responsibility for the regulation of Recognised Clearing Houses (which contain embedded payment systems). The Bank also acts as the designating authority for payment systems under the Settlement Finality Directive, with the FSA as designating authority for systems within Recognised Clearing Houses.

1.86 The Bill will provide that the Bank of England shall be an overseer of payment systems, with a statutory backing. In effect, this formalises the Bank of England's existing responsibilities of ensuring that payment systems generally are robust and effective. However, the Bank of England's statutory oversight will be restricted to those systems whose disruption or failure could have systemic or system-wide consequences.

1.87 The Authorities do not envisage that this provision will amount to a substantial change in practice.

Benefits 1.88 The primary benefit of giving the oversight of payment systems a statutory basis is that it provides the Bank of England with the necessary powers to take action (should informal actions fail in the first instance). In addition, it will give greater clarity for payment systems stakeholders (principally the operators and members). As such, the Authorities believe that the legislative framework for oversight should improve the robustness of payment systems whose failure may have systemic or system-wide consequences.

Quantification: It is not feasible to quantify the benefits of more robust and efficient payment systems, as the resulting benefits are the prevention of any failure. However, payment systems are crucial to the smooth running of the financial sector and their robustness is important to the financial system.

1.89 The tighter scope of oversight to focus on systems with systemic or system-wide consequences could reduce the number of systems overseen by the Bank of England and hence eliminate some costs.

Quantification: It is not possible to quantify this impact until the Treasury has recognised payment systems which are systemic or of system-wide importance.

Costs 1.90 The proposed approach formalises the current informal arrangement between the Bank of England and payment systems. Under the existing arrangements the Bank of England meets with most of the key UK payment systems on a quarterly basis. It also requests information from these systems in order to undertake risk assessment. The Bank of England does not envisage any significant change to this approach under the statutory regime.

1.91 As such, there should be no significant impact on the costs incurred by the payment systems which will be overseen. However, the Authorities recognise that there may be a small increase in costs to the payment systems should they wish to change the way they engage with the Bank of England under a statutory regime.

Quantification: The Authorities believe these costs to be negligible.

1.92 The legislation also gives the Bank of England the power to charge fees for oversight. If they seek to exercise these powers there would be an additional burden on recognised payment systems. The Authorities do not expect that fees charged (if any) will be significant in size. In any case, the legislation provides that the level of any fees be capped by Treasury regulations which will be consulted on in due course.

Quantification: At this stage, negligible.

1.93 The Bank of England is likely to incur a small cost in establishing formal oversight and an ongoing increase in personnel costs to carry out the statutory functions. Any additional costs will be funded from existing resources.

Quantification: It is not expected to be to be more than three full-time equivalent officials.

Groups affected 1.94 The Bank of England, payment systems whose disruption may lead to systemic or system-wide consequences and a small number of infrastructure providers.

Competition Assessment 1.95 This measure should not have a significant impact on competition. Competition issues relating to payment systems will remain the responsibility of the Office of Fair Trading.

Risks 1.96 There is a risk that some costs may be incurred by non-recognised systems if they are asked to provide information to the Bank of England to inform their ongoing assessment of those systems that are future candidates for recognition. However, there is a degree of cooperation and overlap between the Bank of England and the FSA in regulating payment systems, which should minimise this effect.

REDUCING THE IMPACT OF A FAILING BANK

1.97 This section discusses legislative proposals included in chapter three of the July consultation document 'Financial stability and depositor protection: further consultation' and Parts one, two, three and four of the Banking Bill.

Special Resolution Regime

Overview 1.98 The Banking Bill introduces a "special resolution regime" for failing banks.

1.99 This part of the impact assessment covers the special resolution regime as a whole and does not cover the specific tools of the regime, which are covered separately at the end of this section.

Description 1.100 The SRR is, in effect, a set of tools to enable the Authorities to resolve failing banks. These tools will be used in limited circumstances: as acknowledged in the previous consultation documents, any decision to use such tools in the case of a specific firm would be a significant step, and the way in which these tools are deployed will therefore need to be considered very carefully.

1.101 Given this, and the fact that the regime does not impose particular requirements on banks outside of its operation, there are few direct benefits and costs associated with it. It is important to distinguish between benefits and costs arising from the existence of the SRR and benefits and costs arising from its usage. Costs and benefits will in the main be incurred when a failing bank has entered the regime and in these cases will be determined by the particular tool chosen by the Bank of England. These benefits and costs, which are contingent on the powers of the regime being used, need to be separated from any direct benefits and costs.

1.102 The regime does, however, regardless of whether it is invoked or not, carry risks. Some of these risks could have a significant impact. These are discussed in detail below. The Authorities believe, though, that the benefits of the SRR outweigh these risks and that appropriate safeguards can help to mitigate such risks.

Direct benefits 1.103 There are no one-off or ongoing quantifiable direct benefits associated with the SRR.

1.104 There should, however, be some non-quantifiable direct benefits, primarily in the form of confidence in the financial system. Establishing a regime is likely to increase confidence – both at a consumer and wholesale level – in the banking industry. The new tools give bank stakeholders increased certainty that the Authorities will be able to successfully and optimally resolve a bank in severe difficulties.

Indirect benefits

1.105 The two most significant benefits of the SRR are that it reduces the likelihood and the impact of a failing bank. These two benefits, in particular the latter, mean that the overall costs of bank failure should be reduced with the regime in place.

1.106 Reducing the impact of bank failure affects a number of groups:

Depositors – the SRR tools provide for the continuation of banking services, ensuring customers retain access to their deposits, preserving liquidity. In the case of the bank insolvency procedure, depositor payout is the priority, although the deposit transfer function is a form of continuity..

Authorities – the fiscal impact of a bank failure should be reduced as the Authorities have better means to pursue a private-sector solution.

Financial services sector and the wider economy – by isolating bank failure and reducing the risk of contagion, the special resolution regime will benefit economic sectors closely linked to the banking sector.

Quantification: It is not feasible to quantify these benefits because they will vary on a case-by-case basis. However, the 'Costs of financial instability and bank failure' section sets out the benefits of preserving financial stability and preventing bank failure.

Direct costs

1.107 It is expected that there may be some direct costs to the Authorities associated with the costs of implementing the SRR tools. The Bank of England, given its central role in implementing the SRR tools is likely to need to invest in additional resources to enable it to carry out its functions. Its role will involve two elements, preparing for the SRR (for example receiving information from the FSA and surveillance of financial stability in any period before the SRR is invoked) and choosing and implementing the private sector purchaser and bridge bank stabilisation options if it is appropriate to use an SRR tool.

Quantification: The Bank of England is continuing to develop its operational plan as the lead authority in implementing the SRR tools, liaising closely with international counterparts to learn from best practice. At this stage it is estimated that the model will be based on a limited standing staff, whose role will be to monitor situations and contingency plan for use of the SRR tools. When the SRR is invoked, these staff will be supplemented by external professionals such as lawyers, insolvency professionals and banking experts. The standing staff will be ongoing costs, while the contracting of external professionals being one off costs specific to each resolution. It should be noted that even without the SRR, the one off costs and part of the running costs would be incurred as the Authorities currently take the lead monitoring and, if believed appropriate, helping to resolve failing banks- for example, as with Northern Rock. Any additional costs to the Bank of England through its new resourcing requirements will be shared between the Bank of England's own balance sheet (including through funds from the cash ratio deposit scheme), the failing bank itself (for example if consultants were brought into work with the bank while it was a bridge bank, or in preparing for a private sector solution) and the industry through FSCS funding of the SRR- see section below.

1.108 The FSA is the lead authority in deciding whether a bank will enter the SRR. This role will involve ensuring it has adequate information on a bank position in relation to its threshold conditions under FSMA. It may also update its handbook in light of this new role. As the FSA already regulates deposit takers with regard to the Threshold conditions it is not expected that these actions will lead to significant extra cost to industry. It is not expected that the Treasury will have significant extra running or one off costs in line with their duties under the SRR.

Indirect costs 1.109 The indirect costs of the SRR may be defined as the costs incurred as part of any resolution of a failing bank. These costs could include:

- an injection of liquidity, that is a special loan to a bank;
- a public sector liability guarantee;
- additional administrative expenses to the Authorities of appropriate advisers (legal and financial); and
- compensation costs.

1.110 To protect the public interest the Authorities would seek to recover as many of these costs as possible. However, it should be noted that the creation of the SRR should reduce these costs overall from what they otherwise would have been if the Authorities did not have the new tools.

Compensation costs 1.111 The powers of the regime may remove or adversely affect property rights, employment and other private law rights. This would need to be justified in relation to the European Convention on Human Rights (ECHR) and be compatible with Community law obligations. The Authorities believe that such intervention will be justified by the strong public interest grounds. However, to ensure full compliance with the ECHR the Bill provides a number of mechanisms for providing for such compensation as may be payable. These are compensation orders and the bank resolution fund.

1.112 In the case of compensation orders, the value of compensation (if some were due) will be determined by an independent valuer. In the case of a bank resolution fund the proceeds of any resolution (for example from the sale of a bank) will flow back to the compensatable persons. Both the compensation order and the bank resolution fund disapply any financial assistance or resolution costs from the value of compensation. In addition, the Bill allows for valuation principles to be taken into account. These may include that the bank has had its FSMA permission removed or that it is unable to continue as a going concern.

Competition assessment 1.113 The Authorities are continuing to work with the European Commission on competition and State Aid issues.

Risks 1.114 As discussed above, there are certain risks, some significant, to the creation of an SRR for failing banks. A number of these risks would cause costs to the economy, especially the financial services sector, if they fully crystallised. Others could reduce the effectiveness of the regime.

1.115 However, it should be noted that regimes similar to the SRR exist in other countries. Indeed, most G10 countries have special arrangements for dealing with a failing bank, rather than relying on normal corporate insolvency laws. The operation and existence of these regimes suggests that any adverse impact on the financial

markets is modest, whilst accepting that the risks of an SRR regime have to be assessed in the particular context of this country and its financial markets.

1.116 Perhaps the greatest risk attached to the introduction of permanent SRR tools is that, without appropriate safeguards, giving the Authorities broad powers to resolve failing banks could increase the costs of capital and funding for banks. Stakeholders have noted that this risk is greatest for a partial transfer. In broad terms, this could occur if counterparties perceive there to be an increased risk that their property rights will be interfered with. Respondents to the consultation documents, including Financial stability and depositor protection: special resolution regime have noted that this may induce them to either take additional security or increase the price of their lending. In the context of the banking sector the cost of funding relates to the price of borrowing and is one function of banks' cost of business. It is likely that at least a portion of any increase would be passed on to consumers, either through higher costs of banking services or increased charges on borrowing. If this occurred across the banking sector, aggregate consumption and investment could be affected, although effects would be constrained by overseas competition. There is little evidence, however, that the existence of special regimes in other countries has raised the costs of capital and funding for banks. Offsetting this risk is the potential benefit that the legislation could bring to make financial markets work more efficiently and reduce the systemic risk attached to the sector.

1.117 If risks relating to the cost of funding for banks crystallised then it is possible that the attractiveness of London, compared to other financial centres of business, would be reduced. London, and the UK more widely, is generally considered an attractive location to do business. English law is widely acknowledged to be an attractive legal form in which to agree financial transactions.

1.118 The Bill seeks to minimise this risk by introducing a number of safeguards that surround a partial transfer. These safeguards are residual company compensation, a wide protection for set-off and netting arrangements, a limitation on the scope of the partial transfers and residual company creditor compensation. The costs of these safeguards are discussed in the tools section

Stabilisation option – private sector purchaser

Description 1.119 The Government is legislating to provide the Bank of England with powers to effect the private sector purchaser stabilisation option.

1.120 This tool involves the Bank of England using the share or property transfer powers to transfer a failing bank's business to a willing private sector purchaser. A private sector solution is likely to be the resolution outcome that best meets the SRR objectives. Such an outcome has the potential to maintain financial stability, provide continuity of banking services to depositors, achieve desirable outcomes for creditors and counterparties, and protect public funds.

1.121 The private sector purchaser tool would be more flexible than the existing provisions to transfer the business of a bank under Part 7 of the Financial Services and Markets Act 2000 (FSMA). While a Part 7 transfer can overcome many of the difficulties associated with a transfer, it requires a willing seller and willing buyer, an application to court and the chance for affected parties to be heard in court, together with time for various procedural steps to be taken. In the context of a bank in crisis this process is likely to be too uncertain and too lengthy – especially so in the case of a large and complex bank – and could be frustrated for a number of different reasons. Moreover,

Part 7 could only be used to effect the transfer of the assets and liabilities of a bank, not its shares.

1.122 The Authorities believe that the Bank of England should have the power to effect a transfer to a private sector purchaser in situations where the conditions for entering the SRR are met and there are sufficient public interest grounds for intervention. The stabilisation powers would give the Bank of England the means to effect the transfer of a failing bank's business either by the transfer of the bank's shares, or of its property, rights and liabilities, to a private sector purchaser who is willing to accept the transfer.

Costs 1.123 There are two types of costs that will form a part of the transaction.

1.124 First, the Authorities may incur administrative costs in finding and dealing with potential private sector purchasers.

1.125 Effecting a transfer quickly will require the Authorities to have a good understanding of a failing bank's assets and liabilities – the necessary due diligence will probably require additional resources (either from the bank itself or from consultants brought in specifically for the purpose). Such expertise is likely to be of a financial, accountancy and legal nature. If expertise outside of the Authorities or either transacting party is required, the cost is likely to be borne by the purchasing party (although this may vary depending on the circumstances). It is not possible to quantify these costs as they will vary case-by-case.

1.126 Second, a bank which meets the pre-conditions of the SRR will be failing to such an extent that it is likely that a purchaser will only buy the business if there is a sufficient margin of assets over liabilities (that is, solvency is ensured). As such, the Authorities may need to provide some of monetary incentive for the transaction, for example a liquidity or capital injection. This will be a cost of the resolution, and may be covered by the proposal for the FSCS to fund the costs of the SRR – see below for further details. It is not possible to quantify this cost as it will vary case-by-case.

1.127 If a partial transfer is undertaken to a private sector purchaser then additional types of costs may be incurred. The Government is legislating to provide compensation for those creditors left in the residual company following the partial transfer. The amount of compensation is calculated by reference to the difference between what the creditors would hypothetically have received had the Authorities not intervened (and the whole of the bank had gone into insolvency) and the realisations of those creditors from the insolvency of the residual bank (which will include the proceeds of the part of the bank's business which is sold on). This safeguard to creditors may increase the costs of the resolution. This cost should be set in context, as a partial transfer is likely to be less costly than a whole bank transfer.

Benefits 1.128 The wider indirect benefits of the SRR are discussed above.

1.129 The particular benefit of the private sector purchaser tool is that it is likely to be the resolution option that best meets the SRR objectives. In particular, a private sector solution may be less costly to the Authorities (compared to other resolution options) and helps maintain the bank's franchise value.

1.130 By managing the resolution process better, this reduces the risk of a bank failure leading to contagion passing to other banks, which could have a significant impact on the economy. As before, the 'Costs of financial instability and bank failure' section sets out the benefits of preserving financial stability and preventing bank failure.

Bridge Bank Tool

Description 1.131 The Government is legislating to provide the Bank of England with powers to effect the bridge bank stabilisation option.

1.132 This mechanism involves a newly established bank (owned and controlled by the Bank of England) acquiring some or all or the failed bank's assets and assuming some or all of its liabilities (through use of the property transfer powers).

1.133 If the Bank of England decides that a bridge bank is the most appropriate resolution tool, it will establish a separate company, apply for FSA authorisation to carry on the relevant regulated activities and use the property transfer powers to transfer property, rights and liabilities from the failing bank to the bridge bank. A bridge bank will be a company limited by shares wholly owned by the Bank of England.

1.134 Following the transfer, the Bank of England will stabilise the banking business and then put in place an appropriate governance structure to manage the bank's business. Once the Bank of England has selected a suitable private sector purchaser the bank will be sold.

Costs 1.135 In the event that a bridge bank is used, there will be ongoing costs associated with its establishment and operation. These will vary depending upon the nature of any bridge bank. A capital or liquidity injection may also be required on the point of transfer, but this will vary on a case-by case basis.

1.136 In addition, as with the private sector purchaser tool described above, it is likely the Bank of England will need to bring external expertise on board. Such expertise may be appointed as management of the bridge bank or act in an advisory role to the Bank of England. The costs of this expertise will be treated as costs of the resolution

1.137 As the operation of the bridge bank is being undertaken to preserve franchise value and enhance the going concern value of the business, the amount of expenditure should have a positive impact on the price the Bank of England obtains for the bridge bank. Hence the majority of costs should be recoverable.

1.138 If a partial transfer is undertaken to a bridge bank then additional types of costs may be incurred. The Government is legislating to provide compensation for those creditors left in the residual company following the partial transfer. The amount of compensation is equal to the difference between what the creditors would hypothetically have received had the Authorities not intervened (and the whole of the bank had gone into insolvency) and the realisations of those creditors from the insolvency of the residual bank (which will include the funds from the bank resolution fund). This safeguard to creditors may increase the costs of the resolution. This cost should be set in context, as a partial transfer is likely to be less costly than a whole bank transfer.

Benefits 1.139 This tool provides the Bank of England with an opportunity to stabilise the bank, preserve franchise value and ensure consumers have continued access to banking services. Depositors will not be faced with the costs of a bank failure as they will retain access to the full amount of their deposits. It would also provide the Bank of England with time to pursue a private sector solution where this could not have been immediately arranged, for example by allowing potential acquirers to carry out due diligence on the business. If these measures are effective in preserving the net worth of the bank, they should encourage competitive bids from private sector purchasers.

Temporary public ownership

Description 1.140 The Government is legislating to provide the Treasury with powers to effect the temporary public ownership stabilisation option.

1.141 Temporary public ownership would be effected using the share transfer powers.

The tool is subject to a similar public interest test to that set out in the Banking (Special Provisions) Act 2008. Accordingly, the Treasury may only exercise these powers in relation to a bank where it is satisfied that, in addition to the general conditions for exercising stabilisation powers, one of two conditions are met:

- the exercise of the power is necessary to resolve or reduce a serious threat to the stability of the financial systems of the United Kingdom;
- the exercise of the power is necessary to protect the public interest, where the Treasury has provided financial assistance in respect of the bank for the purpose of resolving or reducing a serious threat to the stability of the financial systems of the United Kingdom.

1.142 Temporary public ownership is anticipated to be the most appropriate tool in situations such as the following:

- where a significant amount of public money has been made available to a failing bank in order to stabilise it;
- where wholesale and long-term restructuring is required in order to return the bank to the private sector; and
- where the bank is subject to an extremely fast-burn or complex failure, such that there is insufficient time or means to effect a property transfer or share transfer to a private sector purchaser without significant risk.

1.143 A nominee of the Treasury would be the single shareholder of the shares of the failing bank transferred by virtue of the share transfer order and the Government would seek to introduce corporate governance arrangements in line with best practice as soon as possible in the resolution. Once transferred, a business plan would be agreed so that the objectives of management were the same as the Government's. These objectives would be defined in terms of the SRR objectives. The aim would be to take steps to return the banking business to the private sector swiftly. A bank in temporary public ownership would continue to be authorised and supervised by the FSA.

Costs 1.144 The costs of the tool will be broadly similar to those described for the bridge bank tool.

Benefits 1.145 The benefits of the tool will be broadly similar to those described for the bridge bank tool.

Bank insolvency procedure

Description 1.146 The Banking Bill will introduce a new insolvency procedure for banks - the bank insolvency procedure (BIP)- to ensure that depositors who are eligible for compensation under the FSCS receive prompt payment or have their accounts transferred to another financial institution whilst also providing for the winding up of the affairs of a failed bank in the interests of its creditors as a whole

1.147 Powers are also being taken to enable the bank insolvency procedure to be extended, with modifications where required, to building societies and credit unions by secondary legislation.

1.148 A failed bank would currently be subject to normal insolvency procedures under the provisions of the Insolvency Act 1986 which apply to failed companies generally. These may include the use of administration to try to effect a company rescue or to achieve a better result for creditors than an immediate winding up or liquidation to provide for the orderly realisation and distribution of a failed company's assets to its creditors.

1.149 The bank insolvency procedure is based on the existing compulsory liquidation regime provided for by the Insolvency Act 1986 with additional clauses and modifications to existing insolvency provisions where required.

1.150 Those changes generally reflect and support the achievement of the unique objectives of the bank insolvency procedure which provide for a bank liquidator to work with the Financial Services Compensation Scheme (FSCS) in the early stages of the process to ensure that eligible claimants either receive prompt payment from the FSCS or alternatively have their accounts transferred to another financial institution to ensure continuity in access to funds and banking services (collectively objective 1).

1.151 At the same time the bank liquidator, an insolvency practitioner appointed by the Court, will also be obliged to undertake the usual practices associated with a liquidation to ensure that the winding up proceeds in the best interests of creditors as a whole (objective 2).

1.152 The main changes to insolvency law required for this measure are:

Prior notice of insolvency proceedings – to ensure that the special resolution options, including initiating the bank insolvency procedure, are not frustrated by prior insolvency proceedings, it is proposed that existing insolvency procedures may not be commenced unless 14 days' notice has been given to the FSA. To enable this to work in practice, it is also proposed that a resolution for voluntary winding up will not take effect unless approved by the court.

Restricted rights of creditors in the early stages of the Bank Insolvency Procedure – if a bank has failed, the Authorities would be able to initiate special resolution (either prior to or within the 14-day notice period) immediately. In the early stages of the Bank Insolvency Procedure (up until the achievement of objective 1) the Authorities and the FSCS will form a liquidation committee to work with and generally oversee the proceedings and the actions of the bank liquidator. Due to the need for quick action, there will be no scope for creditors generally to be represented on that initial committee although the whole process will be subject to the overall supervision of the court. Once objective 1 has been achieved, the Authorities' role in the procedure is reduced and the proceedings would continue in much the same way as an ordinary liquidation with a meeting of creditors being called at which, among other matters, the creditors may resolve to form a liquidation committee.

Specific statutory objectives for a bank liquidator – the bank liquidator's objectives would be to: i) work with the FSCS to ensure that either the accounts of eligible depositors are transferred to another financial

institution or compensation payments are made by the FSCS; and ii) wind up the affairs of the failed bank to achieve the best result for the bank's creditors as a whole.

Benefits 1.153 There are no significant ongoing or one-off direct benefits associated with this measure.

Quantification: Negligible.

1.154 Should the new procedure be used, the control the Authorities would have over insolvency proceedings would yield benefits in two main ways:

Speed of process – the Authorities would have the power to initiate proceedings quickly and nominate their preferred insolvency practitioner (whom in a slow-burn scenario is likely will have been engaged pre-insolvency to prepare for such an event, including liaison with the FSCS to plan compensation arrangements). Furthermore, there would not be a requirement to hold meetings with creditors, or seek their views before any action is taken; this should help facilitate a prompt transfer of accounts or quick FSCS payout.

Specific objectives – as creditors' rights are somewhat restricted in the early stages of the proceedings (subject to the procedure being subject to the overall control of the court), this will enable the liquidator to act promptly towards achieving his or her objectives.

Quantification: A prompt transfer of accounts or faster compensation payments decrease the costs to depositors of a bank failure as the length of the time that liquidity is lost is reduced. The new process also avoids, or at least reduces, individual claims processes and paperwork. It is not feasible to quantify these benefits. However, the 'Costs of financial instability and bank failure' section sets out the benefits of quick FSCS payments to depositors.

1.155 Such a regime allows the Government to let a bank fail, to the extent that compensation arrangements for depositors can be quickly effected. Having this option as a credible threat gives appropriate incentives to banks' managers by reducing moral hazard.

Quantification: It is not feasible to quantify these benefits. However, the 'Costs of financial instability and bank failure' section sets out the benefits of quick FSCS payments to depositors.

Costs 1.156 It is unlikely that there would be any material one-off or ongoing direct costs of a new insolvency procedure: it is not anticipated that existing contracts between a bank and its creditors would require rewriting or renegotiation. There will be an additional direct cost where a bank wishes to wind itself up voluntarily since those proceedings cannot now take effect without the permission of the court.

Quantification: Negligible.

1.157 As the bank insolvency procedure is based on existing insolvency provisions, it is not expected that the costs of the insolvency proceedings will materially increase. The prompt compensation arrangements should be put in place quickly and thereafter the proceedings will continue in much the same way as an ordinary liquidation.

Groups affected 1.158 Directly: creditors of any bank taken into the bank insolvency procedure by the Authorities; levy-payers and bank customers generally.

Competition assessment 1.159 As this measure is only an alternative set of proceedings, it is not expected that it will affect competition. Indeed, it may be argued that this measure improves competition as it ensures efficient working of the market, ensuring that insolvency is a viable option.

Risks 1.160 The most significant risk of this proposal is that it might not be in the best interests of all creditors of the bank, because the bank liquidator's primary objective in the early stages of the proceedings will be to work with the FSCS to ensure that eligible claimants receive payment from the FSCS or their accounts are transferred. However, this initial stage in the procedure should be short-lived; the bank liquidator is concurrently also required to carry out actions normally associated with a liquidation (for example identifying, protecting and realising assets, dealing with queries from creditors etc.) and here he would be expected to act in the interests of all creditors generally. It should also be noted that compensation payments will be made by the FSCS rather than from the assets of the failed bank and the FSCS will stand in the shoes of depositors in respect of those claims that it pays. Additionally, no changes are proposed to the existing statutory order of priority of creditors on insolvency and provisions are included for the FSCS to meet the costs associated with a bulk transfer of accounts.

1.161 There is also a risk that the implementation of a bank insolvency procedure could impact on banking groups which contain non-banking lines of business such as insurance. There is a small risk that banks' cost of capital might increase, with wholesale funds supplies demanding higher rates or more collateral. The Authorities believe this risk is small because creditors should not be made any worse off under a bank insolvency procedure than they would under normal insolvency.

Bank administration procedure

Description 1.162 The Banking Bill will introduce a unique insolvency process – the bank administration procedure (BAP)- to facilitate partial transfers. The bank administration procedure could only be invoked where part of a failing bank's business is sold to a private sector purchaser or transferred to a bridge bank and it is considered necessary for the residual banking company to continue to provide ongoing services or facilities to the bridge bank or the commercial purchaser for the parts of the business transferred.

1.163 The bank administration procedure may only be commenced by an order of the court on an application made by the Bank of England. The procedure is based largely on the existing administration provisions of Schedule B1 to the Insolvency Act 1986 but has an additional unique objective requiring the bank administrator (an insolvency practitioner) to provide support for the commercial purchaser or bridge bank. New clauses and modifications to certain existing administration provisions are therefore proposed in order to ensure that this objective can be achieved.

1.164 The bank administrator will also be obliged to carry on the ordinary process of an administration but this will be subject to certain restrictions, for example prior to completion of the 'support objective' certain assets may only be realised and certain actions taken only with the agreement of the Bank of England. The length of time that the residual company may need to be kept alive to provide support will vary on a case-by-case basis. As soon as it is no longer necessary for continued support to be provided

by the residual company to the commercial purchaser or bridge bank, the proceedings will continue in much the same way as an ordinary administration.

1.165 To ensure that the bank administration procedure is a flexible and stand-alone regime the bank administrator will have all the existing powers of an administrator and will also have certain powers normally only available to a liquidator; for example to disclaim onerous property, bring actions before the court for wrongful or fraudulent trading and to be able to make distributions to creditors without requiring the express permission of the court. This means that once the 'support objective' has been achieved, the administrator will have all the tools available that he requires to either attempt a company rescue or to fully wind up the affairs of the bank.

Benefits

1.166 The wider benefits of the SRR and the private sector purchaser and bridge bank tools are discussed above.

1.167 The particular benefit of the bank administration procedure is that it is designed to ensure that where there is a partial transfer, essential services and facilities continue to be provided to the commercial purchaser or bridge bank. The procedure also facilitates, where necessary, further property transfers between the residual company and the commercial purchaser or bridge bank. This will assist the successful resolution of the bridge bank and should make a partial purchase of a failing bank's business by a private sector purchaser a more attractive option. The bank administrator will also have additional powers normally only available to a liquidator which will ensure that the objectives of the proceedings can be achieved and reduce the costs associated with conversion from administration to a liquidation.

Costs

1.168 If a partial transfer is undertaken to a private sector purchaser or bridge bank then additional costs may be incurred. The Government is legislating to provide compensation for those creditors left in the residual company following the partial transfer. The amount of compensation is equal to the difference between what the creditors would hypothetically have received had the Authorities not intervened (and the whole of the bank had gone into insolvency) and the realisations of those creditors from the insolvency of the residual bank (which will include the funds from the bank resolution fund). This safeguard to creditors may increase the costs of the resolution.

Groups affected

1.169 Directly: creditors of any bank taken into the bank administration procedure.

Risks

1.170 The most significant risk of this proposal is that it might not be in the best interests of all creditors of the bank, for example there may be a delay before any distribution to creditors can be made and the dividend prospects may be worse than in an immediate insolvency because the assets of the bank may have been used in achieving the 'support objective'. To mitigate these risks safeguards including compensation, as outlined above, are proposed in relation to the exercise of the SRR tools.

Resolution of building societies and other mutuals

Overview 1.171 The Banking Bill applies the private sector purchaser, bridge bank and temporary public sector ownership tools to building societies and takes a power to apply the Bank Insolvency Procedure and Bank Administrative Procedure to Building Societies. In addition the Government intends to take a power to apply the SRR tools to credit unions in the future should the Authorities believe it is necessary.

1.172 The consultation document 'Financial stability and depositor protection: special resolution regime' proposed that the special resolution should apply for building societies in a similar way as it does for banks. This proposal has been supported by stakeholders. The Banking Bill therefore provides the Authorities with the powers to effect a property transfer of a building society to a private sector purchaser or a bridge bank, or take a building society into temporary public sector ownership. The property transfer to a private sector purchaser or bridge bank tools are similar to the powers used for banks. The temporary public sector ownership tool is slightly different in that the Government, rather than being implemented through a share transfer, will be implemented through the Government becoming the sole member of the building society. The benefits, costs and risks of these tools are assessed to be the same as those outlined for the SRR tools and SRR in general.

Funding the special resolution regime

Description 1.173 The Banking Bill will bring forward legislation so that, in addition to its role in ensuring payout to depositors in the event of the failure of a deposit-taking firm, the FSCS can also be called on to contribute to costs arising from the use of resolution tools. The contribution required from the FSCS will be capped at the hypothetical net cost of the compensation (i.e. the amount of compensation that would have been paid after recoveries had been made by the FSCS) that would have been paid if the bank had gone into default.

1.174 Currently, the costs of bank failure are only borne by financial services providers (in their capacity as levy payers to the FSCS) at the point at which the FSCS is engaged to pay depositors.

1.175 As an alternative, the Government is introducing legislation to provide the FSCS with responsibility for contributing to the cost of using SRR tools, where this would better protect the interests of depositors, and would be no more costly for the FSCS than paying the amount of compensation that would otherwise have been due in a whole bank liquidation.

Benefits 1.176 The use of pre-insolvency SRR tools to resolve a failing bank would be undertaken on the grounds of a number of public interest considerations, including the need to preserve financial stability, to protect the public finances, to protect depositors, and maintain the availability of key banking services for consumers. These considerations, as discussed above, point to significant benefits resulting from the use of the SRR to the economy as a whole.

1.177 In the case of levy payers, the direct benefit of the use of pre-insolvency SRR tools in the absence of any contribution towards the cost, would be the hypothetical cost of compensation had the SRR not been available and the failing bank been put into insolvency (with depositors paid out through the FSCS). It is anticipated that under the proposal to require the levy payers to contribute to the cost of resolution the total benefit may increase, as it is anticipated that the cost of resolution through pre-

insolvency tools may be significantly below the cost of payout in most cases. Therefore there would still be some direct benefit to the levy payers. The position of levy payers would be protected, furthermore, by the provision in the legislation that that their contribution to the resolution cannot exceed the level of the hypothetical cost of compensation. So in the worst-case scenario, the benefit would be nil, rather than any additional cost.

Quantification: It is not feasible to quantify these benefits: they will vary from circumstance to circumstance.

Costs 1.178 There are no significant ongoing or one-off direct costs associated with this measure.

Quantification: Negligible.

1.179 As discussed above, this measure should not increase the costs of resolving a failing bank, indeed it is more likely to decrease them. The transfer of benefits from levy payers to the Authorities will, however, be a cost for the levy payers in instances where the Authorities choose to intervene instead of allowing a bank to go into insolvency.

Quantification: It is not feasible to quantify these costs: they will vary from circumstance to circumstance. Secondary legislation will set out the types of SRR costs that the FSCS will be liable to fund, these could include the market value of any guarantees provided by the Authorities to the creditors of the bank in the SRR; financial assistance provided by the Authorities to support the operation of a bank resolution, or to facilitate a transfer to the private sector; the cost of compensation claims arising from the SRR; and the administrative costs of the SRR- for example some of the costs outlined above that will fall upon the Bank of England in its new role as the lead organisation in the SRR.

Groups affected 1.180 Directly: the FSCS, the failing bank, and the FSCS levy payers.

Competition assessment 1.181 The Government continues to work with the Commission to ensure that international rules facilitate rather than hinder appropriate action by national authorities. The SRR tools, and their funding, will clearly need to be made compatible with all relevant aspects of competition law.

Risks 1.182 There is a risk that the Authorities may not estimate correctly either the costs of the SRR tools or of the hypothetical cost of compensation to eligible depositors had the bank failed. Therefore, both of these measures will be subject to independent assessment.

Financial collateral arrangements

Description 1.183 The Government intends to introduce a power enabling it to make secondary legislation in relation to financial collateral arrangements.

1.184 The Government will consult on the scope of any future regulations to strengthen the protections available to financial collateral arrangements.

Benefits 1.185 There are no significant ongoing or one-off direct benefits associated with this measure. If regulations are introduced that create new protections, these will be subject to a formal impact assessment.

Quantification: Negligible

Costs 1.186 There are no significant ongoing or one-off direct costs associated with this measure. If regulations are introduced that create new protections, these will be subject to a formal impact assessment.

Quantification: Negligible

Groups affected 1.187 The scope of possible future regulations is not known at present but would be likely to affect a wide range of financial market participants. It would be unlikely to directly affect individual consumers.

Competition assessment 1.188 The power has no direct impact on competition. If regulations are introduced that create new protections, these will be subject to a formal impact assessment.

Risks 1.189 The power has no direct impact and hence no direct risks. The future use of this power will be subject to the usual better regulation checks and balances.

CONSUMER CONFIDENCE AND COMPENSATION ARRANGEMENTS

1.190 This section discusses individual proposals included in Chapter 5 of the July consultation document 'Financial stability and depositor protection: further consultation' and Parts four, six and seven of the Banking Bill to confer new powers on the Treasury to make regulations or to confer new powers on the FSA to make rules.

1.191 The Chapter 5 proposals relating to compensation discussed here are:

- enabling the FSA to collect information on behalf of the FSCS before the default of a firm;
- enabling the FSCS to obtain information from firms after the default of a firm but before a claim has been made;
- for streamlining the FSCS claims process;
- ensuring the FSCS has access to immediate liquidity through borrowing from the Government;
- pre-funding; and
- increased management flexibility for the FSCS

Allowing the FSA to collect information on behalf of the FSCS

Description 1.192 The Banking Bill will enable the FSA to collect information from firms that the FSCS requires (and share this with the FSCS) before default.

1.193 Currently, the FSA cannot obtain information not directly required for its own regulatory functions. Additionally, the FSCS does not have the power to obtain information from firms before claims for compensation have been made.

1.194 This proposed power would enable the FSA to obtain information that the FSCS needs. This information would be primarily used for the purposes of assessing the adequacy of the bank's systems to provide the Authorities with the information needed to assess whether payout is practical, and when necessary to prepare for compensation payments to be made, should a bank fail.

1.195 The FSA will carry out a cost-benefit analysis as part of the process of making rules under new powers conferred by the legislation.

Benefits 1.196 In the event of a bank getting into difficulties, this measure allows the FSCS to be better prepared to process payments quickly, should compensation be required. A quicker compensation payment reduces the costs to depositors of a bank failure as the length of the time that liquidity is lost is reduced.

Quantification: It is not feasible to quantify these benefits. However, the 'Costs of financial instability and bank failure' section sets out the benefits of quick FSCS payments to depositors.

Costs 1.197 The FSA and FSCS may use some additional resources (by way of administrative expenses) on potentially both a regular (in the case of ongoing supervision) and one-off (in the time preceding a set of payments) basis.

Quantification: In the case of the FSA this is likely to be absorbable within existing supervisory resources without difficulty. Some extra FSCS staffing, however, may be required. This has been estimated at less than £100,000 per year.

1.198 Banks should not incur materially higher resource costs as a result of this measure as it only relates to the provision of existing information to the Authorities.

Quantification: Negligible.

Groups affected 1.199 Directly: the FSA, the FSCS, and any bank required to provide information. Indirectly: any depositor benefiting from a quicker payment as a result of this measure.

Competition assessment 1.200 This measure should not have a significant impact on competition.

Risks 1.201 There is a risk that allowing the FSCS access to information before a bank's default could detrimentally affect consumer confidence and undermine efforts to resolve a potential failure. This risk will be mitigated by the Authorities taking actions to ensure that such information requests do not become public and in any event, information audits will become routine.

1.202 There is also the risk that this measure will unnecessarily increase the requirement on banks to provide information. This might occur, for example, if the trigger for determining when the FSCS requires access to preparatory information is set too early, or any routine steps are too burdensome.

Allowing the FSCS to obtain information from firms at an earlier stage

Description 1.203 The Banking will allow the FSCS to require and obtain information directly from firms as soon as a firm is declared in default.

1.204 Currently, the FSCS can only obtain information directly from a firm once a compensation claim has been made.

1.205 Under the proposed new powers, the FSCS would be able to obtain information from the time a firm goes into default, if that happens at an earlier stage.

Benefits 1.206 There are no significant ongoing or one-off direct benefits associated with this measure.

Quantification: Negligible.

1.207 This proposal would allow the FSCS to begin processing compensation payments earlier. (This would also be a benefit of the proposal to allow claims to be deemed to be made – see Streamlining the FSCS claims process below.) A quicker compensation payment reduces the costs to depositors of a bank failure as the length of the time that liquidity is lost is reduced.

Quantification: It is not feasible to quantify these benefits. However, the 'Costs of financial instability and bank failure' section sets out the benefits of quick FSCS payments to depositors.

Costs 1.208 There are no significant ongoing or one-off direct costs associated with this measure. This is because the amount of information being required is the same; it is just the timing that is different.

Quantification: Negligible.

Groups affected 1.209 Directly: the FSCS and any bank going into default. Indirectly: eligible depositors of a failed bank who may benefit from quicker compensation payments.

Competition assessment 1.210 This measure should not have a significant impact on competition.

Risks 1.211 None identified at this stage.

Streamlining the FSCS claims process

Description 1.212 The Banking Bill will give the FSA the power to make new rules to specify the circumstances in which consumers need to make a formal claim to the FSCS before receiving a compensation payment and to allow for the automatic conferral of rights on the FSCS to make recoveries in place of claimants.

1.213 The current claims process involves a round of written correspondence between the insured depositor and the FSCS. The objective of these rule changes is to remove these administrative stages.

1.214 As part of the new process, claimants will need not actually apply to the FSCS for compensation. The FSCS would instead make payments to depositors based on the records of the bank. If the depositors accepted the payment, there would be an automatic conferral on FSCS of rights of recovery.

Benefits 1.215 There are no significant ongoing or one-off benefits associated with this measure.

Quantification: Negligible.

1.216 In the event of compensation payments being made, this measures allows the FSCS to process payments quicker than it would otherwise. Faster compensation payments decrease the costs to depositors of a bank failure as the length of the time that liquidity is lost is reduced.

Quantification: It is not feasible to quantify these benefits. However, the 'Costs of financial instability and bank failure' section sets out the benefits of quick FSCS payments to depositors.

1.217 Additionally, there may be an administrative cost saving in the event of a compensation payout, as there is likely to be a reduced checking time for claims and less paperwork for individual claims to establish eligibility.

Costs 1.218 No significant ongoing costs associated with this measure are envisaged. However, faster payout could potentially increase funding costs for the levy payers. Also, the FSCS is likely to have to review claims in more detail after they have been paid and to recover overpayments in appropriate cases. It is likely that the FSCS will have to invest in its technology systems, in order to facilitate this proposal and may have to incur some higher running costs.

Quantification: At this stage, the capital investment (one-off) for this measure is estimated at between £1.5 million and £3.0 million. Additional running costs cannot be quantified at this stage.

Groups affected 1.219 Directly: the FSCS. Indirectly: depositors eligible for compensation in the event of a bank failure.

Competition assessment 1.220 This measure should not have a significant impact on competition.

Risks 1.221 There is a greater risk of claims being paid in error. This measure also carries greater risks that cheques will be intercepted and fraudulently encashed or of other forms of fraud.

1.222 The FSA will carry out a cost-benefit analysis as part of the process of making any rules and it will be able to explore the risks of fraud and other forms of loss and the costs of measures to control these risks, in more depth when considering whether and in what way to exercise the powers conferred by the legislation.

FSCS access to liquidity for compensation payments

Overview 1.223 The Banking Bill will:

- ensure the FSCS has access to immediate liquidity through borrowing from the National Loans Fund; and
- include powers which would allow the introduction of pre-funding of the FSCS if it was considered appropriate to do so in the future.

1.224 Currently, the FSCS is funded on a 'pay as you go' basis, with annual levies on firms based on the expected outgoings, including compensation payments, for the following year. The FSCS covers all sectors of financial services, and has a unified funding model, which has been recently reviewed by the FSA after extensive consultation and which came into force on 1 April 2008. If unexpected payments need to be made, the FSCS can borrow until it has been able to collect sufficient levies to repay the borrowing and the interest on these loans.

1.225 To facilitate fast payments to customers of a medium-sized or large bank, or to make a contribution to the costs of the application of the SRR in such a case, access to immediate liquidity on a much larger scale would be needed and it is possible that it would be difficult to raise the sums required by borrowing from commercial banks. The

FSCS currently has a commercial borrowing facility of about £50 million but paid out approximately £14 billion to enable retail deposits held in Bradford & Bingley to be transferred to Abbey. It financed this payout through a short-term loan from the Bank of England and the purpose of the part of the Bill is to put a permanent arrangement to enable the FSCS to have access to loans of such a size.

Borrowing from the Government

Description 1.226 The Banking Bill will enable the FSCS to borrow from the National Loans Fund.

The Government would become a creditor of the FSCS in the ordinary way – exactly as if the FSCS had borrowed from a commercial lender. These loans will have to be repaid with interest (charged at the appropriate market rates) out of future levies on the industry.

Benefits 1.227 The benefit of this option is that it allows faster payment. Faster compensation payments decrease the costs to depositors of a failed bank as the length of the time that liquidity is lost is reduced. It also allows levies to industry to be managed by setting the terms of repayment appropriately.

Quantification: It is not feasible to quantify these benefits. However, the 'Costs of financial instability and bank failure' section sets out the benefits of quick FSCS payments to depositors.

Costs 1.228 There are no significant ongoing or one-off direct costs associated with this measure.

Quantification: Negligible.

Groups affected A.1 Directly: the FSCS, the Government. Indirectly: eligible depositors of a failed bank who may benefit from quicker compensation payments.

Competition assessment A.2 This option should not have an effect on competition, if a commercial rate of interest were charged (which would be required in order to comply with EC State aid rules).

Risks A.3 None identified at this stage.

Pre-funding

Description A.4 The Government intends to legislate to take powers to make regulations to introduce pre-funding into the FSCS. There will be further consultation by the Treasury and a more detailed impact assessment prepared before any regulations are made; the regulations would be subject to the affirmative resolution procedure.

Benefits A.5 The principal benefit of pre-funding is that the cost of any default can be recovered from the industry over a longer period of time, including the period before a default when the financial system is likely to be less stressed. Pre-funding would reduce the need for the FSCS to meet its immediate funding needs by borrowing from the market or public sector. Pre-funding also ensures that a failed firm will have contributed to the costs of compensating its customers. But it would never be possible to build up a fund that would be large enough to guarantee that there would never be a need for the FSCS to seek additional levies after a default to meet the costs of that default, or remove the need for the FSCS to have access to liquidity by borrowing from the public sector to further smooth the cash flow impact on the industry.

Quantification: Monetising the benefit of pre-funding is difficult as it depends on the specific circumstances of individual bank failures. However, given the importance of banks to credit intermediation, there may be benefits in having a smoother profile and less pro-cyclical pattern of FSCS levy demands.

Costs 1.229 There are two costs to pre-funding. The first is simply the administrative costs of running a pre-funded scheme. In practice, these would amount to the costs of managing the investments of the fund. But as the Government now proposes that the funds should be deposited in the National Loans Fund, these costs should be negligible.

Quantification: Significantly less than £0.5 million.

A.6 The second cost is the cost to the firms in terms of the return foregone on investing the levies less the return on the investment in the National Loans Fund until the time when a levy demand under the existing (post-funded system) would have been made. Firms would need to expend capital on annual contributions to the fund (until the point the target fund size was reached) that they may have placed in alternative – and higher returning – investments. Contributing to a fund held in the National Loans Fund would mean that levy-paying banks' profits would be lower, though less risky, than were banks able to invest these funds elsewhere. There would, therefore, be opportunity costs for levy payers in establishing such a fund. But this implicitly assumes that the banks would have to meet a levy demand at some point equal to the amount that had been invested in the contingency fund. To the extent that the contingency fund more than covered future compensation payments, or that there were no more bank defaults, the cost to the banks would be equal to the whole amount of the return foregone. It is not possible to quantify this risk (that the contingency fund was never needed) but it possible to estimate the net opportunity cost for a range of realistic scenarios about the maximum size of fund and the time taken to build it up.

Quantification: This opportunity cost is the differential between the return to the assets in the fund and the return on banks' equity, appropriately adjusted for the higher risk of bank equity, multiplied by the size of the fund levied from the industry. The difference is the equity risk premium.

There is evidence that the UK equity risk premium is approximately 4.5 per cent. For the purposes of this approximation, this figure is halved to compensate for the higher risk of equities over gilts. Using this assumption and building up a fund to a maximum of £13 billion, we can estimate what the opportunity cost to industry would be in several scenarios on an annual basis over 20 years. We have assumed that contributions will stop once the fund target size of £13 billion has been reached. .If we envisage a ‘high’ scenario, where the fund would be built up at a rate of £1.5 billion per year, a ‘medium case’ of £1 billion per year and a ‘low case’ of £0.5 billion per year, the average annual opportunity cost to the banks over twenty years would be around £236 million for the ‘high’ case, £200 million for the ‘medium’ case and £118 million for the ‘low ‘case.

A fund of 1.5 per cent of protected deposits in the UK would total roughly £13 billion. Some pre-funded depositor compensation schemes in other countries typically hold funds of 1-2 per cent of protected deposits. However, whether this was the appropriate sum for the concentrated banking system existing in the UK would need to be considered. Further, it could take a number of years to build up a fund of such size.

If a decision were taken for the Government to use this power to implement pre-funding, this would require a statutory instrument to be taken through Parliament via the affirmative procedure. The SI would be subject to a consultation period and a full

impact assessment, where the possible forms pre-funding might take would be further explored and quantified.

Groups affected 1.230 Directly: FSCS levy payers and the FSCS.

Competition assessment 1.231 FSCS levies on banks are proportional to their market share of protected deposits, so introducing an element of pre-funding would not distort competition among existing deposit takers, regardless of their size. Steady funding over a number of years also tends to reduce the distortions to market entry and exit: there is no particular timing advantage or disadvantage to entering or leaving the market shortly after a large payout, as there is under current pay-as-you-go funding.

1.232 However, new entrants to the market will be required to begin paying levies immediately, rather than have a contribution 'holiday' until the next payout from the fund under the existing post-funded arrangements. This may deter entry into the sector.

Risks 1.233 There is a risk that pre-funding could encourage banks from other EEA states to switch from having subsidiaries in the UK to operating via branches here of banks in other Member States.

FSCS Management flexibility

Description 1.234 The Bill includes provisions to confirm that:

- the cost of payments made in error can be met from the levies the FSCS collects from the financial services industry;
- the FSCS may delegate its functions to an agent who acts on its behalf.

1.235 These measures will ensure that the FSCS has the management flexibility it needs to deal with a potentially large but fluctuating volume of claims. The first measure puts beyond doubt that the FSCS does not have to pursue recoveries from claimants who have received overpayments of compensation where it is not cost effective to do so. The second measure allows greater delegation of decision-making authority, on a controlled basis (for example to certain staff of a bank liquidator), if it is cost effective. This measure would help provide a faster payout to claimants at a lower cost.

Benefits 1.236 The direct benefits of these measures will be lower management expense (all resource costs) for the FSCS. Also, in the event of compensation payments being made, these measures allow the FSCS to process payments quicker than it would otherwise. Faster compensation payments decrease the costs to depositors of a bank failure as the length of the time that liquidity is lost is reduced.

Quantification: It is not feasible to quantify these benefits. However, the 'Costs of financial instability and bank failure' section sets out the benefits of quick FSCS payments to depositors.

Costs 1.237 There are no significant ongoing or one-off direct costs associated with this measure.

Quantification: Negligible.

Groups affected

1.238 Directly: FSCS levy payers, the FSCS and depositors who have been paid out in error.

Competition assessment

1.239 These measures should not have any effect on competition.

Scottish and Northern Ireland Banknotes

Description

1.240 The Banking Bill strengthens the arrangements underpinning banknote issuance by commercial banks in Scotland and Northern Ireland.

Proposals

1.241 The aim of the proposals is to ensure that holders of Scottish and Northern Ireland banknotes will be afforded a similar level of protection to holders of Bank of England banknotes and, in the unlikely event of an issuing bank failing, can expect to obtain full face value for their banknotes. The Government supports the continuation of the long-standing tradition in Scotland and Northern Ireland of banknote issuance and is not seeking to discourage note issuing commercial banks from continuing to issue their own banknotes.

1.242 The key features of the framework are:

- the issuing banks will have to hold certain assets ("backing assets") to at least match the value of their banknotes in circulation at all times
- no less than 60% of the value of banknotes in circulation must be backed by Bank of England banknotes and/or current UK coin;
- the remaining value of banknotes in circulation and the value of banknotes with the potential to enter circulation (for example, in bank branch tills, ATMs and in transit) will be permitted to be backed wholly by way of an equivalent amount in a segregated interest-bearing account at the Bank of England, remunerated at Bank Rate;
- the minimum value of backing assets to be held must be reassessed each week, on the basis of the weekly peak level of banknotes; and
- backing assets will be legally ring-fenced for the benefit of noteholders in the event of an issuing bank failing.

Consultation

1.243 The Government first consulted on this issue in 2005, when all consultation responses supported the principle of noteholder protection, but a number of respondents claimed that the detail of the proposals went beyond what was necessary to protect noteholders.

1.244 The proposals were subsequently refined in light of responses and details were published in the January and July consultation documents of 2008 [13]. The proposals now incorporate a level of cover above that which was initially provided in 1845, to more accurately reflect current practices and provide greater confidence to noteholders.

[13] "Financial stability and depositor protection: strengthening the framework" January 2008 and "Financial stability and depositor protection: further consultation" July 2008

Benefits 1.245 The current proposals in the Banking Bill will have the following effect:

- the principle benefit of these proposals is to ensure that if a note issuing bank gets into financial difficulty, noteholders can continue to have confidence that they will receive full value for the notes that they hold; and
- the Bank of England, in line with its expertise in banknote issuance, will assume regulatory responsibility. There will be a small resource saving for Her Majesty's Revenue and Customs, whose historical administrative function in relation to commercial banknote issuance is no longer core to its objectives.

Quantification: The benefits relate to maintaining confidence in UK currency (and reducing the financial impact on holders of Scottish and Northern Ireland banknotes if a note-issuing bank were to get into financial difficulty), and as such, are not quantifiable. The administrative savings to HMRC are negligible.

Costs 1.246 There may be some additional resource costs to the issuing banks, arising from complying with the new regulatory framework. For example, they may be required to provide more detailed management and audit information. However, the presence of such costs is currently uncertain and if they do materialise, are not expected to be significant.

Quantification: The Government has worked closely with the issuing banks in developing the proposals regarding the issue of Scottish and Northern Ireland banknotes and will continue to work with them to ensure a smooth transition to the new framework when it is implemented. The costs to the issuing banks are expected to be negligible, but will be considered in greater detail as part of the associated affirmative secondary legislation.

1.247 The Bank of England will incur costs in performing its regulatory role. However, the Authorities do not believe these will be significant.

Quantification: The Bank of England estimates its marginal costs to be £300,000 per year.

Groups affected 1.248 The reforms will affect the seven commercial banks which issue banknotes in Scotland or Northern Ireland. The position of holders of Scottish and Northern Ireland banknotes, as creditors, will be affected in the event of an issuing bank failing. The transfer of regulatory responsibility will affect Her Majesty's Revenue and Customs and the Bank of England.

Competition assessment 1.249 The Authorities do not believe that these changes will have a detrimental impact on competition. No concerns regarding competition were raised by the financial services industry in their consultation responses. One consumer group expressed a view that the note-issuing privilege of issuing banks could be seen as distortive.

Risks 1.250 Should an issuing bank decide to cease issuing its own banknotes, there could be an additional cost to the Bank of England if it needs to increase its own production and distribution of banknotes to compensate.

Scottish cheques

Description 1.251 The Banking Bill brings the law in Scotland relating to the treatment of cheques in line with that in the rest of the United Kingdom.

1.252 In Scots Law, under the funds attached rule, when a cheque is presented to a bank for payment the sum stated on the cheque is assigned to the payee out of the funds held by the bank for the drawer of the cheque. Thereafter, neither the drawer nor the bank (on the drawer's behalf) may deal with that sum. Problems arise in practice when there are insufficient funds to satisfy the cheque or multiple cheques are presented simultaneously. In those circumstances, the bank makes no payment.

Benefit 1.253 Abolition of the funds attached rule in Scots Law, insofar as it relates to cheques, removes an administrative cost for clearing banks in Scotland and reduces associated expense and inconvenience for the banks' customers.

Quantification: The abolition of the funds attached rule would remove an administrative cost for clearing banks in Scotland estimated to be approximately £300,000 per year.

Costs 1.254 The Government does not believe that this measure will lead to costs for any of the affected parties.

Quantification: Nil.

Groups affected 1.255 Abolition of the funds attached rule will benefit the four clearing banks in Scotland. Drawers and payees of cheques in Scotland will also benefit from this reform.

Competition assessment 1.256 Implementation of the cheques reform will enable the clearing banks in Scotland to deal with cheques in the same way as banks in the rest of the United Kingdom.

Risks 1.257 None identified.

COORDINATED ACTION

1.258 This section discusses proposals included in the July consultation document 'Financial stability and depositor protection: further consultation' and Part seven of the Banking Bill

Statutory changes to the Bank of England

Description 1.259 The Government intends to legislate for a number of changes to strengthen the Bank of England.

1.260 Currently, the Bank of England does not have a statutory obligation for financial stability. However, the Bank of England does have a statutory objective to discharge its monetary policy duties. Existing legislation also sets out the structure and responsibilities of Court. Court consists of the Governor, two Deputy Governors and 16 Directors. The Directors are all non-executive. The duties of Court are to manage the Bank's affairs, other than the formulation of monetary policy, which is the responsibility of the Monetary Policy Committee. There are a number of aspects of Court that are not consistent with corporate governance best practice.

1.261 The Banking Bill will formalise the Bank of England's role in the area of financial stability, create a Financial Stability Committee that would be a sub-committee of the Court and bring the structure of Court further in line with corporate governance best practice by reducing the number of members of Court, providing that Court is chaired by one of the non-executive directors and reducing the number of meetings of Court to a minimum of seven per year

Benefits 1.262 These changes should improve accountability and the response of the Bank of England to issues relating to financial stability.

Quantification: It is not feasible to quantify these benefits. However, the 'Costs of financial instability and bank failure' section sets out the benefits of preventing financial instability.

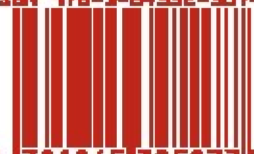
Costs and benefits 1.263 The modifications to the role and governance of the Bank of England will produce several small changes in their costs. The reduction in the number of non-executive directors of Court will reduce costs overall, but on the other hand, it is probable that the remuneration paid to future non-executives will be higher, to reflect the relative change in workload and expertise requirements. Similarly, the creation of a new committee will create marginal additional administration costs. The fact that Court will not be required to meet as frequently should save some administrative costs. We expect the net impact of these changes to be minimal.

Quantification: Negligible.

Groups affected 1.264 Directly: the Bank of England.

Competition assessment 1.265 This measure should not have a significant impact on competition.

Risks 1.266 None identified at this stage.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