These notes refer to the Financial Services (Banking Reform) Act 2013 (c.33) which received Royal Assent on 18 December 2013

FINANCIAL SERVICES (BANKING REFORM) ACT 2013

EXPLANATORY NOTES

COMMENTARY

Part 1 – Ring-Fencing

Ring-fencing

Section 4: Ring-fencing of certain activities

26. *Section 4(1)* inserts new Part 9B (ring-fencing) into FSMA.

27. *New section 142A(1)* defines "ring-fenced body" for the purposes of FSMA, as any UK institution which carries on at least one core activity for which it has been given a Part 4A permission under FSMA. *Subsection (2)* excludes building societies from the definition of "ring-fenced bodies" and gives the Treasury power to exclude other institutions from the definition by order. This power will enable the Treasury to provide that only banks above a certain size will be required to be "ring-fenced bodies". *Subsection (3)* sets out the condition which must be satisfied before the Treasury are able to make such an order: the Treasury must be satisfied that excluding the classes of institution in question from the definition of a ring-fenced body would not harm the continued provision in the United Kingdom of core services. *Subsection (4)* requires the Treasury to consider the impact the exercise of their powers to exempt certain UK institutions from the definition of "ring-fenced body" might have on competition in the provision of core services, and whether any adverse impact might be mitigated. *Subsection (6)* allows the Treasury to set conditions on the grant of an exemption from the definition of a "ring-fenced body", and *subsection (7)* defines "UK institution" for the purposes of the section.

28. *New section 142B* defines "core activity" for the purpose of FSMA. *Subsection (2)* provides that the regulated activity of accepting deposits is to be a core activity, but also gives the Treasury power to provide for exceptions to this, by making an order setting out circumstances in which accepting deposits is not to be treated as a core activity. The Treasury therefore have power to provide (for example) that accepting deposits of high net-worth individuals, or large corporate entities, is not a core activity, so that such deposits may be held in banks which are neither ring-fenced bodies nor exempt under section 142A(2) from the obligations that apply to ring-fenced bodies.

29. *Subsections (3) and (4)* set out the conditions which must be satisfied before the Treasury are able to make an order setting out circumstances in which accepting deposits is not a core activity. The Treasury must be satisfied that it is not necessary for accepting deposits in those circumstances to be treated as a core activity either to protect the depositors specified in the order, or to protect the continued provision of the core services in the United Kingdom.

30. *Subsection (5)* gives the Treasury power to provide for additional core activities (and, when creating a new core activity, to provide for the circumstances in which the carrying on of the activity concerned is not to be considered to be a core activity).

31. *Subsection (6)* sets out the conditions which must be satisfied for the Treasury to designate a new core activity by order. First, the Treasury must be satisfied that an interruption in the provision of the services which are provided in the carrying on of that activity would harm UK financial stability (or the financial stability of a significant part of the UK financial system), and secondly, the Treasury must consider that making the activity in question a core activity is a more effective way of protecting the continued provision of those services.

32. *New section 142C* defines "core services" for the purposes of FSMA. *Subsection (2)* defines the "core services" which are associated with the core activity of accepting deposits (the only core activity specified in primary legislation), by identifying the categories of services which are to be "core services". It will not be necessary for ring-fenced bodies to provide every possible service which could be described as falling into these categories. Some banks only provide for certain forms of payment from their accounts. Some banks may choose not to provide any overdraft facilities. S*ubsection (3)* gives the Treasury power to require that any service not included in the categories listed in *subsection (2)* which is provided in connection with the core activity of accepting deposits is also to be considered to be a core service. *Subsection (4)* requires that, when the Treasury creates a new core activity in the exercise of its power under section 142B(5), the Treasury must also identify those services provided in the course of that activity which are to be core services.

33. The definition of core services is intended to be comprehensive, and those services which do not fall within the categories of services listed in *subsection (2)*, and are not specified as core services in an order made by the Treasury under *subsection (3)* or *(4)* will not be core services, however closely they are associated with a particular core activity.

34. *New section 142D* defines "excluded activity" for the purposes of FSMA. *Subsection (2)* provides that the regulated activity of dealing in investments as principal is an excluded activity, but also gives the Treasury power to provide for exceptions to this, by making an order setting out the circumstances in which dealing in investments as principal is not to be an excluded activity.

35. *Subsection (3)* sets out the condition which must be satisfied before the Treasury may make such an order. The Treasury must be satisfied that allowing ring-fenced bodies to deal in investments on their own account in the specified circumstances will not cause significant harm to the continued provision of core services in the United Kingdom.

36. *Subsection (4)* gives the Treasury power to provide for additional excluded activities (and, when creating a new excluded activity, to provide for the circumstances in which the carrying on of the activity concerned is not to be considered to be an excluded activity). *Subsection (5)* clarifies that the activity concerned need not be regulated under FSMA. *Subsections (6)* and *(7)* set out the conditions which must be satisfied before the Treasury may provide for an additional excluded activity. Under *subsection (6)*, the Treasury are required to consider the risks which would arise for the ring-fenced body in the event that it carried on the activity concerned, and whether permitting a ring-fenced body to carry on that activity would increase the risk that its failure would harm the continued provision of the core services in the UK. *Subsection (7)* requires the Treasury to be of the opinion that it is necessary or expedient to make the order to protect the continued provision in the UK of the core services.

37. *New section 142E* gives the Treasury power to make an order imposing prohibitions on ring-fenced bodies. *Subsection (1)* specifies the prohibitions which may be imposed in such an order. *Subsection (2)* specifies the conditions which must be satisfied before the Treasury may make such an order. The Treasury must have regard to the risks to

which a ring-fenced body would be exposed if it did anything the Treasury propose to prohibit in the order, and consider whether allowing a ring-fenced body to do the things prohibited in the order would increase the chance that the failure of the ring-fenced body would harm the continuous provision of the core services in the UK. Under *subsection (3)*, the Treasury must also be of the opinion that it is necessary or expedient to make the order to protect the continued provision in the UK of the core services. Under *subsection (4)* an order made under this section may also contain exemptions from the proposed prohibitions, and make any such exemptions subject to conditions.

38. *New section 142F* makes additional provision as to what may be included in an order made by the Treasury under new sections 142A, 142B, 142D or 142E. In particular, the Treasury are given power to confer powers on either the FCA or the PRA in such an order. They may authorise the regulator to make rules or other instruments, and, under *subsection (2)*, make the exercise of the regulator's new powers (including any rule-making power provided for) subject to conditions or requirements set out in the order. The Treasury are also permitted to include in an order made under these provisions references to publications of different bodies (such as rules made by one of the regulator) as those publications are amended from time to time.

39. *New section 142G* provides for the consequences where a ring-fenced body carries on any excluded activity, or contravenes any prohibition imposed under new section 142E. Under *subsection (1)* a ring-fenced body which has done this is treated as having contravened a requirement imposed on that body by the regulator under FSMA. It will in consequence be liable to the disciplinary measures and penalties which the regulators may impose under Part 14 of FSMA. However, under *subsection (2)*, the ring-fenced body will not have committed a criminal offence solely by reason of the contravention, and transactions entered into contrary to a prohibition remain valid. Further, no-one will be able to rely on the contravention to bring an action for breach of statutory duty against the ring-fenced body, unless the Treasury make express provision for this in the exercise of the power given in *subsection (3)*. *Subsection (4)* defines "the appropriate regulator" for the purposes of the section.

40. *New section 142H* makes provision requiring the PRA and the FCA to make rules about ring-fencing. It requires (in *subsection (1)*) the appropriate regulator (which will be the PRA in relation to PRA-authorised persons, and the FCA in relation to other authorised persons) to make rules ensuring that ring-fenced bodies have appropriate arrangements in place for the supply of services and facilities which they need to carry on the core activity. *Subsection (1)* also requires the appropriate regulator to make rules for certain purposes ("the group ring-fencing purposes"), which apply to ring-fenced bodies and to authorised persons that are members of a ring-fenced body's group. The group ring-fencing purposes are set out in *subsection (4)*. They are intended to ensure that a ring-fenced body has the ability to take decisions for itself, and is both economically and operationally independent of the other members of the group, in the sense that it is not reliant on resources provided by the group and would be able to continue carrying on the core activities even if one or more other companies in the group become insolvent. Further, the areas where the regulator is required to make rules for the group ring-fencing purposes are listed in *subsection (5)*. Each area is concerned with the regulation of the relationship between the ring-fenced body and the group: such as the terms on which it contracts with other members of the group (*paragraph (a)*), payments it may make to the group (*paragraph (b)*), disclosure of intra-group transactions (*paragraph (c)*), and the composition and independence of its board of directors (*paragraph d)*). In addition, the regulator is required to make rules in relation to the remuneration and human resources policies (defined in *subsections (6)* and *(7)* respectively) of a ring-fenced body, and its risk management arrangements (*paragraphs (e), (f)* and *(g)*), to ensure that these policies and arrangements are separate to those of other companies of the group. Finally, in *paragraph (h)*, the regulator is required to make any other rules which it considers to be necessary or expedient to achieve the purposes set out in *subsection (4)* whether or not the rules concerned fall within one of the areas listed in *subsection (5)*. These provisions do not limit the general

rule-making power of either regulator. Each regulator may also make any other rules it considers to be necessary or expedient, in the case of the PRA, for the purpose of advancing its general objective or, in the case of the FCA, to advance one or more of its operational objectives.

41. *Subsection (2)* of *new section 142H* provides that the power given to the Treasury in section 142E(1)(c) to prohibit ring-fenced bodies from holding shares or voting power in other companies in specified circumstances does not prevent the regulator exercising its own power to make general rules imposing restrictions in this area, but rules made by the regulator are subject to any such provision made by the Treasury. For example, if the Treasury made an order which prevented a ring-fenced body from having a shareholding of more than 10% in a certain type of company, it would not be possible for the regulator to make rules preventing ring-fenced bodies from having shareholdings of more than 5%.

42. *New section 142I* gives the Treasury power to specify further what matters must be dealt with by rules made by the regulator in each of the areas specified in *section 142H(5)*, or to require the regulator to make rules in other areas, if this is necessary to ensure the independence of the ring-fenced body from the other members of its group.

43. *New section 142J* requires the PRA (and where relevant the FCA) to carry out a review of their ring-fencing rules and of any rules they have made under section 192JA applying to parent undertakings every five years, to report to the Treasury on that review, and publish the report. The Treasury must lay a copy of the report before Parliament.

44. *New sections 142K to 142V* set out the powers of the PRA and the FCA to require groups including a ring-fenced body to restructure themselves, and provide for the procedure which must be followed when those powers are exercised. *New section 142K* sets out four conditions at least one of which must be satisfied before "the group restructuring powers" (see section 142L) may be exercised. Conditions A to C reflect the group ring-fencing purposes provided for in section 142H: under condition A, the regulator must be satisfied that the ring-fenced body's core business is being harmed by the conduct of a member of its group, under condition B, the regulator must be satisfied that the ring-fenced body cannot carry on that business independently of its group, and under condition C, the regulator must be satisfied that the insolvency of a member of its group would prevent the ring-fenced body carrying on its core business. Under Condition D, the group restructuring powers may be exercised if the regulator is satisfied that the conduct, present or past, of a member of the group is making it more difficult to achieve the continuity element of the regulator's objective. It is only necessary for one of the four conditions to be satisfied for the regulator to be able to exercise the group restructuring powers.

45. *New section 142L* sets out the group restructuring powers for each regulator. Any authorised person in the group, and any UK incorporated parent undertaking of the ring-fenced body, may be required to divest itself of specified property (including shareholdings in the ring-fenced body, or any other member of the group) and to apply to the court for approval of a ring-fencing transfer scheme, to enable it to transfer part of its business to another entity. This section also provides for the case where the PRA or the FCA wishes to impose a requirement on an entity for which it is not the appropriate regulator. The PRA is given power to require the FCA to impose the relevant requirement. The FCA is given an equivalent power where it is the appropriate regulator, and it wishes to impose a requirement on a PRA-authorised person. The powers set out in this section include a power to require a ring-fenced body to make arrangements discharging it from liabilities specified by the regulator (*subsection (5)(c)*). In some cases the regulator may be able to impose the same requirements on authorised persons under sections 55L or 55M. *Subsection (8)* makes it clear that this does not affect the regulator's use of the group restructuring powers set out in this section.

46. *New section 142M* requires the regulator to issue preliminary notices where it proposes to exercise any of the group restructuring powers. Notices must be given to the person on whom the requirement is imposed (referred to as "the person concerned"), to the ring-fenced body and to any other authorised person who may be affected by the exercise of those powers. The preliminary notice must state what action the regulator proposes to take, and why the regulator considers that the group restructuring powers have become exercisable. A copy must be provided to the Treasury. The recipients of the notice (referred to as "the relevant persons") are given the opportunity to make representations to the regulator.

47. *New section 142N* sets out the next stage of the process. After the issue of the preliminary notice, the regulator may at any time give the relevant persons a notice stating it will not exercise its group restructuring powers. However if it proposes to continue it may take no further action for a period of 3 months. Once that period has expired it has 3 months within which to decide whether to proceed by issuing a warning notice. The regulator must take into account any representations made by the relevant persons in response to the preliminary notice and anything done by those concerned to address its concerns in the period since the end of the preliminary stage, and must obtain the consent of the Treasury before it may issue a warning notice. The regulator is not limited to exercising the group restructuring powers in the way specified in the preliminary notice – if circumstances have changed (or if the person concerned consents) the warning notice may specify different action.

48. Following the warning notice, after consideration of any representations made in response to it, the regulator must within a reasonable period issue a decision notice setting out the action it proposes to take. After those representations have been considered, the regulator may issue a decision notice. The decision notice must specify the date by which any divestment required by the notice has to be completed.

49. *New section 142O* gives those who have received a decision notice in relation to the exercise by either regulator of its group restructuring powers (or who should have received such a notice under *new section 142N*) the right to refer the decision to the Upper Tribunal.

50. *New section 142P* permits the regulator to vary any requirement imposed in the exercise of its group restructuring powers, provided that the person concerned consents to the variation. The PRA may also vary a direction given to the FCA requiring it to impose a requirement on the person concerned, and the FCA may vary a direction when it has used its equivalent power to direct the PRA. Anyone who is a person concerned may apply for a variation of a requirement imposed on them. Such an application is subject to the same procedure as an application for a variation of a Part 4A permission given under FSMA 2000.

51. *New section 142Q* provides that where the PRA is considering imposing a requirement on an authorised person that is not a PRA-authorised person by way of a direction to the FCA, the PRA must consult the FCA before giving a preliminary notice, warning notice or decision notice in the proceedings. The FCA would be subject to the same requirement if it wished to direct the PRA to impose a requirement on a PRA-authorised person.

52. *New section 142R* explains the relationship between the group restructuring powers and the powers of the regulator to impose requirements on authorised persons or to direct qualifying parent undertakings to take specified action under the existing powers referred to in *subsection (6).* The regulator is not permitted to exercise its existing powers to effect a change of control of the ring-fenced body so that it is no longer controlled by an existing member of the group, or to require companies in the same group as a ring-fenced body to cease undertaking any excluded activity. Subject to this, the regulators' powers under sections 55L, 55M and 192C are not in any way limited by the provisions of new sections 142K to 142Q.

53. *New section 142S* enables the regulator to impose penalties on, or publish a statement of censure in relation to, a qualifying parent undertaking who has breached a direction given under new section 142L. Such action may not be taken outside the limitation period (as defined in *subsection (5)*).

54. *New section 142T* sets out the procedure the regulator must follow before taking action under section 142S. *Subsection (7)* provides that a person who has received a penalty or been the subject of a statement of censure may refer the matter to the Tribunal.

55. *New section 142U* requires a regulator to provide a copy of any statement of censure to certain persons (including the person in respect of whom it is made).

56. *New section 142V* requires the FCA and PRA to prepare a statement of policy with respect to the imposition of, and amount of, penalties under new section 142S. The regulator must have regard to any such statement when exercising its power to impose a penalty. The statement must be published, and a copy must be provided to the Treasury.

57. *New section 142W* gives the Treasury power to make regulations in relation to the pension liabilities of ring-fenced bodies. Under *subsection (1)* they may require requiring ring-fenced bodies to make arrangements to ensure that they will only be liable for pension liabilities arising after a specified date in connection with employment in a ring-fenced body in relation to their pension liabilities, and that their liabilities in relation to pension liabilities arising before that date cannot be increased by the default of any other person. Where this is not possible, the regulations may require ring-fenced bodies to take steps to minimise their potential pension liabilities. Under *subsection (2)* the regulations may also enable the trustees or managers of pension funds to transfer all or part of the pension liabilities arising before the specified date to another pension scheme, or to divide their existing pension scheme into two or more sections. Under *subsections (3) and (4)* where ring-fenced bodies have been unable to reach any agreement with third parties necessary to enable them to make arrangements for the purposes set out in subsection (1), the regulations may enable them to apply to the court for an order requiring the third party to enter into appropriate arrangements on commercial terms.

58. *Subsection (6)* contains a non-exhaustive list of the provisions that may be included in the regulations. Many are provisions which will enable a ring-fenced body to make arrangements under existing pensions legislation, by removing potential obstacles. For example, the terms of a pension scheme may need to be modified and the trustees may have no power to do this. The regulations could give the trustees power to modify the scheme, but only with the consent of the participating employers. Similarly, the arrangements a ring-fenced body may need to make may require trustees' consent. If the trustees unreasonably refuse consent the regulations can enable a court to dispense with the need for consent. But the regulations cannot allow a court to dispense with consent where consent has been withheld reasonably. The regulations may provide that a contravention of a requirement included in them is to be treated in the same way as a contravention of a requirement imposed by the PRA under FSMA. The effect of this would be to ensure that the disciplinary powers available to the PRA under FSMA could be used to penalise any contravention of the regulations. The regulations may also modify, exclude or apply existing legislation.

59. Under *subsections (7) and (8)*, a ring-fenced body may be required to do all it can to obtain a clearance statement from the Pensions Regulator under sections 42 or 46 of the Pensions Act 2004 (or under equivalent provisions of the Pensions (Northern Ireland) Order 2005) in relation to anything it does to comply with the regulations.

60. *Subsection (9)* provides that if a ring-fenced body is not a PRA-authorised person, references to the PRA are to be read as references to the FCA.

61. *Subsection (10)* provides that regulations made by Treasury under this section may not require ring-fenced bodies to make arrangements in accordance with regulations made

under this section before 1 January 2026. Though the Treasury may require preparatory steps to be taken earlier than 2026, this means ring-fenced bodies will have until at least 2026 to ensure they have made the arrangements necessary to comply with regulations made under new section 142K.

62. *New section 142X* contains interpretative provisions applying to section 142W.

63. *New section 142Y* gives the Treasury power to make an order regulating the way in which the PRA and the FCA may exercise their functions under FSMA to impose requirements on a relevant body as to the debt which must be issued or maintained by that body. The ICB recommended that certain banks should be required to hold minimum levels of debt (or extra capital in its place if a bank chooses to do this). This is intended to facilitate the exercise of the new powers proposed in the Recovery and Resolution Directive. If, for example, a bank suffers a significant drop in the value of its assets, the powers proposed in the Directive may be exercised to impose a reduction in the value of the obligations due under the bank's debt before the bank actually becomes insolvent, so reducing the chance that the bank will need to be liquidated, undermining the stability of the financial system.

64. The Treasury may wish to specify which types of debt instrument can count towards the minimum level of debt recommended by the ICB, as the Treasury must be satisfied (and markets must believe it credible) that resolution authorities would be both prepared and able to impose losses on a bank's creditors in a crisis situation. For example, the Treasury may decide it is necessary for eligible instruments to have at least 12 months remaining on their term, because investors in longer-term instruments would be less able to withdraw their investment in the bank by demanding that their debts are repaid as a crisis approaches, and because this would give the authorities responsible for exercising the powers proposed in the Recovery and Resolution Directive a grace period to exercise those powers, restructure the firm if necessary, and restore market confidence before it needs to refinance these debt instruments.

65. *Subsection (2)* defines "relevant body" for the purpose of the section. Ring-fenced bodies will be relevant bodies, but the definition is not limited to ring-fenced bodies. A body corporate which has permission under FSMA to accept deposits, and a body corporate which is a member of the same group as a ring-fenced body or of another body corporate which has permission under FSMA to accept deposits which is not itself a ring-fenced body will also be "relevant bodies" for the purposes of this section. Relevant bodies will therefore include any global systemically important banks which are based in the UK, even if the bank in question is not a ring-fenced body. *Subsection (3)* defines "debt instrument" for the purposes of the section. The definition is a broad one: all forms of debt including bonds and any form of transferable debt would be covered. *Subsection (4)* contains a non-exhaustive list of the provisions that may be included in an order made by the Treasury under this section. The Treasury may both require the regulator to impose specified debt requirements on a relevant body, and limit the requirements which may be imposed. They may set out the matters to which the regulator must (or must not) have regard or refer to. They may require the regulator to consult or obtain the consent of the Treasury before it exercises its powers or require the regulator to make additional procedural provision in relation to the exercise of its functions. The Treasury may also refer in an order to a publication of any body in the UK or abroad (such as rules made by the regulator), as that publication is in force for time to time.

66. *New section 142Z* makes provision for the draft affirmative resolution procedure to be used in relation to orders made by the Treasury under the provisions listed in *subsection (1)*, so that no such order may be made unless the draft order has been laid before Parliament and approved by each House (*subsection (2)*). *Subsections (3)* to *(6)* provide for the application of the made affirmative resolution procedure to apply to orders made under sections 142D(4) (new excluded activities) and 142E (prohibitions), where the Treasury consider that the matter is urgent so that it is not appropriate to proceed by the draft affirmative procedure. If this applies, the order may

be made without being approved in draft, but it must be approved by each House of Parliament within 28 days from the day on which it is made if it is to continue in force (*subsection (4)*).

67. *New section 142ZI* explains how the references to the regulated activities of accepting deposits and dealing in investments as principal, and the references to the group restructuring powers are to be understood for the purpose of Part 9B of FSMA.

68. The effect of the amendment to section 133 of FSMA 2000 (proceedings before Tribunal: general provision) in *section 4(2)* is to include in the list of "disciplinary references" references to the Tribunal in relation to decisions to impose a penalty under section 142S or to issue a statement under that section censuring a qualifying parent undertaking.

69. *Section 4(3)*provides that the regulators may, if they consider it appropriate, publish details of any warning notice given under section 142N (procedure: warning notice and decision notice) in relation to the proposed exrcise of the group restructuring powers.

70. *Section 4(4)* ensures that third parties affected by the issue of a warning notice or decision notice to a qualifying parent undertaking benefit from the rights in FSMA to receive a copy of that notice; and that those qualifying parent undertakings on which warning notices or decision notices are served will be given access to FCA or PRA material in relation to the decision.

71. *Section 4(5)*of the Act inserts definitions of "core activities", "core services", "excluded activities", "ring-fenced body" and "ring-fencing rules" into section 417 of FSMA.

72. The amendments made by *section 4(6) and (7)* add the function of issuing statements of policy under new section 142V (with respect to the imposition and amount of penalties which may be imposed under section 142S) to the list of legislative functions of the FCA and the PRA respectively. This means that the PRA or the FCA must act through their governing bodies when issuing such statements of policy, and may not for example discharge this function through a sub-commitee or an officer or member of staff.