Title: Financial Services Bill **IA No:** RPC-HMT-5000(1) **RPC Reference No:** RPC-HMT-5000(1) **Lead department or agency:** HM Treasury **Other departments or agencies:** N/A	**Impact Assessment (IA)** **Date: 21/10/2020** **Stage:** Final **Source of intervention:** Domestic **Type of measure:** Primary Legislation **Contact for enquiries:** Perry Scott; Perry.Scott@HMTreasury.gov.uk.

Summary: Intervention and Options

RPC Opinion: FIT FOR PURPOSE

Cost of Preferred (or more likely) Option (in 2019 prices)			
Total Net Present Social Value £m	**Business Net Present Value** £m	**Net cost to business per year** £m	**Business Impact Target Status** N/A

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

The UK's financial services sector plays a crucial role supporting the UK economy, and the Government is committed to ensuring its continued success. The Financial Services (FS) Bill brings forward measures that will ensure that the UK maintains its world-leading regulatory standards and remains open to international markets now that it has left the EU. As a global financial centre, certain changes are required to ensure that the UK's financial services regulatory framework remains at the forefront of international standards, and able to manage potential risks to financial stability. The Bill also brings forward measures to maintain the effectiveness of the FS regulatory framework and sound capital markets.

What are the policy objectives and the intended effects?

The Bill aims to enhance the UK's world-leading prudential standards by implementing the remaining changes recommended by the Basel committee and delivering a more proportionate prudential regime for investment firms. It puts in place long-term market access arrangements for FS firms based in Gibraltar; simplifies the process for overseas funds to market in the UK; and will ensure that the Financial Conduct Authority (FCA) can manage the transition away from the LIBOR benchmark, to protect financial and market stability. It makes a number of other changes to ensure the continued effectiveness of the FS regulatory framework.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

The different policy options for each measure are described in the following sections of this document. For each measure, the impacts have been assessed against a "do nothing" baseline and alternative policy options, including non-regulatory options, have been explored where appropriate.

In general, regulation is the most appropriate way of ensuring that the financial services sector operates effectively, as firms need to have a clear understanding of their responsibilities, and the ability to compare regulatory requirements across different jurisdictions. A number of these measures are amendments to existing regulatory regimes to make them more proportionate or effective. For the measures relating to consumer protection and access to finance, clear regulatory standards are considered appropriate in order to ensure strong protections.

Will the policy be reviewed? It will not be reviewed. **If applicable, set review date:** N/A

Does implementation go beyond minimum EU requirements?		N/A		
Is this measure likely to impact on international trade and investment?		Yes		
Are any of these organisations in scope?	**Micro** Mixed	**Small** Mixed	**Medium** Mixed	**Large** Mixed
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)		**Traded:** **N/A**	**Non-traded:** **N/A**	

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

Signed by the responsible Minister: [signature] Date: 21st October 2020

Summary: Analysis & Evidence

Description: Implementing the measures in the Financial Services Bill

FULL ECONOMIC ASSESSMENT

Price Base Year 2019	PV Base Year 2019	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: N/A	**High:** N/A	**Best Estimate: N/A**

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low	N/A		N/A	N/A
High	N/A		N/A	N/A
Best Estimate	N/A		N/A	N/A

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

N/A

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

While the Bill does not result in direct costs to businesses, it will enable a series of changes that may ultimately result in costs for UK businesses. These are likely to include potential familiarisation costs, compliance costs, requirements to change systems, and staffing costs. This Impact Assessment sets out the current understanding of the costs associated with each measure and further detail will be set out in the Impact Assessments for the secondary legislation and in the cost benefit analysis undertaken by the relevant financial services regulator, as appropriate.

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	N/A		N/A	N/A
High	N/A		N/A	N/A
Best Estimate	N/A		N/A	N/A

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

N/A.

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

While the Bill does not result in direct benefits to businesses, it will enable a series of changes that may ultimately result in benefits to UK businesses. This includes a reduction in the operational burden on overseas funds seeking UK recognition, increasing choice for UK investors; more proportionate capital requirements for investment firms; and reducing the risk of market disruption caused by the end of the LIBOR benchmark. Consumers will benefit from improved options for managing problem debt, and improved outcomes for people on low incomes looking to develop long-term savings habits. This Impact Assessment sets out the current understanding of the costs associated with each measure and further detail will be set out in the Impact Assessments for the secondary legislation and in the cost benefit analysis undertaken by the relevant financial services regulator, as appropriate.

Key assumptions/sensitivities/risks	**Discount rate**	N/A

The ultimate impact on businesses will be determined by the subsequent legislation and regulations made following this Bill.

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			**Score for Business Impact Target (qualifying provisions only) £m:**
Costs: N/A	**Benefits:** N/A	**Net:** N/A	**N/A**

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Introduction: Financial Services Bill Impact Assessment

1.1 The financial services (FS) sector plays a crucial role in supporting the UK economy, creating jobs across the UK, supporting SMEs, contributing taxes, driving regional growth and investment, tackling climate change and embracing technology and innovation. It employs more than 1 million people across all four nations of the UK, with two thirds of them based outside London. The sector also contributed £122 billion to the UK economy in 2019 and £75.5 billion in tax in 2018/19[1] - helping to fund vital public services.

1.2 The future success and competitiveness of the UK financial sector will be underpinned by a world-class environment for doing business. Having left the EU, there will be some areas where the UK – as a large and complex financial services jurisdiction – will take an approach which better suits our market, while remaining consistent with the highest international regulatory standards.

1.3 The Financial Services Bill will be the first step in this process: underpinning the continuing global competitiveness of the UK's financial services sector by enhancing its world-leading prudential standards, promoting openness to international markets, and helping consumers access financial services while protecting vulnerable groups. The result of extensive industry engagement, the Bill delivers on a number of existing Government commitments that will ensure the sector continues to thrive in the UK.

1.4 Following the UK's departure from the EU, the Government will also take the opportunity to more fundamentally review our financial services regulatory framework, and make sure that it best meets the needs of the UK, and is fit for the future. To this end, HM Treasury launched the Financial Services Future Regulatory Framework Review in July 2019. This is a long-term review looking at how the UK's regulatory framework needs to adapt for the future following the UK's exit from the EU – including the role of Parliament, HM Treasury and the financial services regulators (the Bank of England and the Financial Conduct Authority). An extensive consultation process is underway to consider these issues.

1.5 The Financial Services Bill will begin the process of adapting the regulatory framework to reflect the UK's new position outside the EU.

1.6 The Bill will:

i. **Enhance the UK's world-leading prudential standards and promote financial stability.** The Bill will implement an **improved prudential regime for investment firms** to make the rules that apply to them more proportionate when compared to systemically important banks. It will increase the UK's resilience to economic shocks by updating its prudential regulatory regime in line with the latest global **Basel 3 and Basel 3.1 banking standards**. It will give the FCA the power it needs to oversee the **orderly wind down of LIBOR**, reducing significant risks to market stability. It will also **extend the transitional period for third-country benchmarks** from end-2022 to end-2025, avoiding financial stability risks and economic repercussions for UK users.

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[1] TheCityUK (2020). Available at: https://www.thecityuk.com/assets/2020/Reports/05a3382368/Key-facts-about-UK-based-financial-and-related-professional-services-2020.pdf

ii. **Promote openness to overseas markets.** The Bill will deliver on a ministerial commitment to **provide long-term market access between the UK and Gibraltar for financial services firms**, recognising the UK's special historic relationship with Gibraltar. It will **simplify the process which allows overseas investment funds to be marketed in the UK** to maintain the UK's position as a centre of asset management and provide more choice to UK consumers.

iii. **Maintain the effectiveness of the FS regulatory framework and sound capital markets:** The Bill will also make a number of amendments to the UK's regulatory framework, to keep it up-to-date and effective. It will **streamline the process for the FCA to remove a firm's authorisation** and their position on the public register, which will improve accuracy and reduce the risk of fraud. It will **amend the Market Abuse Regulation to bolster its effectiveness**, while reducing the administrative burden on issuers. It will **extend the penalties for financial market abuse**, to bring them in line with comparable economic crimes such as fraud. The Bill will further tackle criminality by helping us **combat illicit finance and promote beneficial ownership transparency of UK-linked trusts based abroad.** The Bill will **strengthen the Breathing Space** scheme by allowing for creditors to be compelled to give vulnerable debtors a Statutory Debt Repayment Plan as part of the scheme, offering respite from problem debt, and **improve the Government's Help-to-Save programme** which supports those on low incomes to build up savings. It will empower the FCA to **improve the functioning of Packaged Retail and Insurance-based Investment Products Regulation.** It will **ensure that clearing members and those offering clearing services do so on a fair, reasonable, non-discriminatory and transparent basis.** It will provide certainty to markets by **clarifying existing legislation on Financial Collateral Arrangements**. The Bill will also **make the appointment of the FCA Chief Executive subject to a clear, once renewable 5-year term**.

1.7 Together, these measures will support the UK's position as a global leader in the financial services sector.

1.8 The measures in the FS Bill do not directly impact on UK businesses. In the majority of cases, the Bill measures will enable a series of changes which require further action from HM Treasury (in the form of secondary legislation) or the Financial Services regulators – the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA), in the form of regulatory rules.

1.9 Where this is the case, the approach taken in this impact assessment is to explain the rationale for taking action, explain the other options considered, and to set out the anticipated costs and benefits based on HM Treasury's current understanding of how the changes will subsequently be implemented. This is in line with the guidance set out in section 1.2 of the Government's Better Regulation Framework[2].

1.10 The final impact will be dependent on subsequent decisions by the Government and the regulators, regarding how to use their powers under the Bill. Where HM Treasury makes secondary legislation using the powers granted through the Bill, it will carry out

[2] Better Regulation Framework, Section 1.2. Available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/872342/better-regulation-guidance.pdf

impact assessments for that specific legislation, where appropriate. These will specify the costs and benefits of the changes made in that secondary legislation, at a more granular detail than is possible when considering the primary legislation.

1.11 Where appropriate, the Financial Services and Markets Act 2000 (FSMA) requires that the regulators consult on draft proposed rule changes, and that this consultation is accompanied by a Cost-Benefit Analysis.

1.12 The measures outlined below will be implemented through the Financial Services Bill and will come into force following Royal Assent of the Bill. Some measures however require further secondary legislation or regulator rules before they come in to effect. Details of implementation plans have been outlined where this is the case.

1.13 Several measures in the Financial Services Bill will have resource implications for the FCA and the PRA. As these are public bodies, these impacts do not contribute to the equivalent annual net direct cost to business (EANDCB). However, this Impact Assessment provides some detail of the impacts where this is significant and it is possible to do so.

Enhancing the UK’s world-leading prudential standards and promoting financial stability

Investment Firms Prudential Regime and Amendments to Markets in Financial Instruments Regulation

Problem Under Consideration

2.1 Prudential regulation seeks to ensure financial institutions control risks and hold sufficient capital to continue to provide services to the real economy. Prudential requirements are typically designed to:

i. Ensure financial institutions remain financially viable and are able to carry out operations through periods of economic stress;

ii. Enable the wind down of failing financial institutions without increasing the risk to the stability of the markets in which they operate.

2.2 Prudential requirements are expected to strike a balance between ensuring the safety and soundness of financial institutions, while avoiding the imposition of excessive costs which could hinder the carrying out their business activities in a viable way.

2.3 At present, UK authorised banks, building societies and investment firms[3] (‘regulated firms’) are regulated under the Capital Requirements Regulation (CRR) and the Capital Requirements Directive (collectively, this is the CRDIV package). These regulations determine the prudential requirements for these regulated firms. For example, regulated firms may have to hold a certain level of capital, have sufficient assets to be able to sustain substantial withdrawals and keep operating, and follow reporting and disclosure procedures.

2.4 The requirements of the CRDIV package apply to all regulated firms within scope, including investment firms. There are currently 3194[4] investment firms operating in the UK[5]. These investment firms conduct different activities to banks and building societies, are exposed to different risks, and most are not considered of systemic importance to the UK financial system[6]. The prudential framework applied to investment firms should reflect these differences in activities conducted by investment firms, the risks they face, and the potential for harm to consumers and to markets.

Legislative context

2.5 In December 2017, the European Commission issued a proposal for a new prudential regime for investment firms[7]. This proposal led to an Investment Firms Regulation and

[3] For investment firms, ‘authorised’ refers to investment firms that are authorised under the Markets in Financial Instruments Directive II (MiFID II).
[4] FCA internal data.
[5] See European Commission Staff Working Document SWD(2017)481: *Review of the prudential framework for investment firms*.
[6] Of the 3194 investment firms in the UK, it is expected that the PRA to determine that eight are of systemic importance to the UK financial system.
[7] See an overview of the Commission’s work in this area here.

Directive (IFR/IFD), which entered into force in December 2019 and will become applicable in the EU from 26 June 2021.

2.6 IFR/IFD introduces a new prudential regime for non-systemic investment firms, which addresses the specific risks faced by these firms and caters for the differences in business models and activities of investment firms. Systemic investment firms (currently eight UK-based firms which by their size, activities and interconnectedness with the rest of the financial system are considered to pose a risk to the stability of financial markets) continue to remain under the CRDIV package (regulated by the PRA) as these firms present risks which are similar to those of credit institutions.

2.7 The UK was instrumental in the introduction and negotiation of IFR/IFD and supports its objectives. However, it will not become part of the retained law under the European Union (Withdrawal) Act 2018 because the date at which IFR/IFD becomes applicable is after the end of the transition period.

Rationale for Intervention

2.8 Investment firms differ from banks and building societies in that they do not typically accept deposits or grant traditional loans. This means that, whilst there is some overlap in business activities, the risks faced and posed by investment firms are different to risks faced and posed by banks and building societies. The current prudential regulatory framework does not adequately cater for these differences, allowing for disproportionate prudential requirements to be applied to investment firms.

2.9 Over time, there have been significant changes to the prudential framework for banks and building societies. The Basel Committee on Banking Supervision (BCBS) has introduced a series of internationally agreed standards which have made prudential requirements increasingly more complex. The Basel standards – introduced in the EU through CRR/CRDIV – are calibrated to banks, building societies and other credit institutions. Consequently, this has meant that investment firms are subject to a prudential framework which is largely based on the risks posed to banks and building societies.

2.10 The consequence of having investment firms adhering to a prudential framework based on risks to banks and building societies is that the current prudential framework for investment firms:

i. **Is mainly disproportionate** – the requirements do not account for differences in size or business models of investment firms.

ii. **Fails to cater for specific risks to investment firms** – the requirements are currently based on risks to which investment firms may not be exposed, whilst insufficiently addressing risks to which they have a significant exposure.

iii. **Imposes unnecessary administrative and compliance burdens** – this is as a result of having to "comply" with a regime for which much of the administration, compliance, and reporting is not designed for investment firms.

2.11 The Government intends to work with the FCA to address these issues by introducing a new prudential regime for investment firms operating in the UK.

Policy Objective

2.12 The Government and the FCA intend to introduce a new Investment Firms Prudential Regime (IFPR), which achieves similar outcomes to the EU's IFR/IFD but tailored to account for the specificities of the UK market. The UK was heavily involved in the policy development of IFR/IFD at EU level, and supports its overall goals of a more appropriate prudential regime that upholds financial stability and promotes competition. Therefore, the UK regime intends to reflect:

i. the number, size and nature of investment firms within the UK;

ii. the structure of a UK-only market and how it operates;

2.13 In that context, the IFPR aims to:

a. Address the specific vulnerabilities and risks inherent to investment firms;
b. Have a prudential framework which is proportionate to:

    i. The size of investment firms;
    ii. The nature, scope and complexity of the activities conducted by investment firms;
    iii. The interconnectedness of investment firms with other financial and economic actors.

c. Capture, where relevant, the potential harm these firms pose to their clients, markets and to the firms themselves;
d. Ensure that these firms are managed in an orderly way, in the best interest of their clients.

Consultations

2.14 The European Banking Authority (EBA) published a discussion paper for a new prudential regime for investment firms on 4th November 2016 and this was open for three months. Its work was also supported by a detailed data-gathering exercise with the help of national competent authorities, which helped to verify stakeholders' responses to the discussion paper.

2.15 In parallel, the European Commission held roundtables and workshops covering the proposed future regime, the costs of the regime and the EBA's draft final recommendations.

2.16 The EBA outlined its draft recommendations in July 2017 and delivered its final report in September 2017. The analysis from the EBA's final report is drawn on in this impact assessment.

2.17 Regarding the UK IFPR, the Government expects the FCA to consult when making rules. The FCA has already published a Discussion Paper on the EU's IFR/IFD, ahead of making rules for IFPR. These consultations are likely to inform further impact assessments of secondary legislation and the cost-benefit analysis of the FCA's rules.

Description of Options Considered

2.18 **Option 0: Do nothing** – under this option, investment firms would remain subject to the CRDIV package. This would mean that UK investment firms continue to abide by requirements which are disproportionate to their size, business activities and the risks they face. Moreover, IFR/IFD becomes applicable in June 2021. This means that investment firms in the EU will be on a more proportionate prudential regime, which in turn would allow EU investment firms to be more competitive than UK investment firms.

2.19 **Option 1 (Preferred option)** – Implement a new prudential regime for investment firms based on a tailored version of IFR/IFD, through the Financial Services Bill.

Policy Outline

Provisions in the Financial Services Bill

2.20 The aim of this primary legislation is to ensure that the FCA has the appropriate powers to fulfil its duty to introduce a new prudential regime for investment firms.

2.21 The detail of the IFPR and the specifics of key policy choices will be made through FCA rules. Amendments in secondary legislation will also be necessary. Detailed impact assessments or cost benefit analyses will accompany these as and when they are considered. In addition, the FCA will be subject to a new accountability framework when making rules for this regime[8].

2.22 Nevertheless, it is the Government's and the FCA's intention that the IFPR will broadly reflect the objectives of the IFR/IFD. This means that the cost and benefits assessed as part of the EU's published IFR/IFD can be compared to those of the UK's IFPR. In that context, in this impact assessment the Government has endeavoured to assess the costs and benefits of the EU's IFR/IFD as it would apply to the UK, in order to provide an estimate of the impact of the IFPR. The specific costs and benefits of the UK regime will be set out in the FCA's cost/benefit analysis of changes to their rules, and impact assessments for any relevant secondary legislation.

Detail of the Regime

Primary legislation

2.23 In primary legislation, the IFPR will require the FCA to introduce new requirements for FCA investment firms in four areas. These are:

i. Capital requirements – capital requirements determine how much capital a firm must hold against their exposures. IFPR will set capital requirements in accordance with the risk to the firm, the risk to the market and the risk to customers.

[8] See HM Treasury policy statement: *Prudential standards in the Financial Services Bill: June update*.

ii. Liquidity requirements – liquidity requirements ensure an investment firm have a sufficient level of liquid (i.e. redeemable) assets to cover sustained outflows over a period of time.

iii. Reporting requirements – these requirements dictate that firms must report their level of capital, capital requirements, liquidity position and other financial position metrics to the supervisory authority.

iv. Public disclosure requirements – these requirements ensure important financial information is published by the investment firm on a regular basis.

2.24 The IFPR will also require the FCA to introduce rules for investment firms to monitor and report concentration risk[9]; for the purposes of this impact assessment, concentration risk is considered part of the costs relating to capital, liquidity and reporting requirements.

2.25 Primary legislation will also amend the Capital Requirements Regulations to ensure it ceases to apply to investment firms, other than those designated to be regulated by the PRA. It also amends the Markets in Financial Instruments Regulation (MiFIR) to provide the UK with the ability to assess and grant equivalence to third countries under MiFIR, in line with the amendments introduced by the EU IFR.

FCA rules

2.26 The FCA's rules will establish the specific requirements of the regime in accordance with (i), (ii), (iii) and (iv) in paragraph 2.23. The detail of the most significant requirements is outlined below.

2.27 Capital requirements form a significant part of IFPR and can be calculated in three ways:

i. **Permanent minimum capital requirement (PMC)** – this is the amount of capital firms need to hold on an ongoing basis. It is equal to the minimum level of capital firms must have in order to be authorised as investment firms.

ii. **Fixed overheads requirement (FOR)** – this is set at a quarter of annual fixed overheads. This is to ensure there is a minimum level to the capital requirements – a 'floor'.

iii. **'K-factors'** – these are proxies designed to measure the firms' risk to customers, risk to markets and risk to clients. The overall K-factor capital requirement is the sum of each individual K-factors, which is in turn linked to the business model of the investment firms. A formula for this can be found in Annex A.

[9] Concentration risk is the risk from being significantly exposed to a single type of asset, institution or sector.

2.28 The method for which a firm's capital requirement applies is related to a set of classifications into which a firm may be placed. These are:

i. Systemic investment firms and large non-systemic firms (or 'Class 1') – These firms will remain subject to the CRDIV package as their risks are similar to those of banks. IFPR will not apply to them. There are currently eight such investment firms in the UK[10].

ii. Other non-systemic investment firms (non-SNIs, or 'Class 2') – all other non-systemic investment firms that do not fall within the definition of 'small and non-interconnected investment firms' will be subject to the new prudential framework.

iii. Small and interconnected firms (SNIs, or 'Class 3') – these firms are considered small due to the nature of their activities and size and therefore only a subset of new regime should apply to them, such as simplified reporting requirements.

2.29 With regards to the methods of calculating capital requirements, Class 2 firms' requirements are based on whichever is highest of PMC, FOR or K-factors methods. Class 3 firms' capital requirements are based on whichever is highest of PMC and FOR methods.

2.30 Liquidity requirements also form a core part of the IFPR. Liquidity requirements dictate the volume of liquid assets a firm must have in order to meet its obligations over a period of stress. Under IFR/IFD, this is set at one third of FOR requirements. Given that FOR requirements are 25% of annual fixed overheads, this makes the liquidity requirement effectively 1-month FOR.

2.31 It should be noted that this IFR/IFD will set Pillar 1 requirements, which in the EU prescribe capital requirements for investment firms in legislation and in the UK will be specified in the FCA's rules. Pillar 2 requirements, which are applied by the FCA on a discretionary and firm-by-firm basis, will continue to apply as appropriate, although they are not within the parameters of this impact assessment (see 'risks, assumptions and limitations' section)[11].

Policy Costs

2.32 This section assesses the costs of Policy Option 1 using the 'Do Nothing' option as the counterfactual. This impact assessment uses the EU's IFR/IFD scheme as a proxy for potential impacts on UK firms. The exact costs and benefits of this measure will be determined when the FCA introduces the new rules. As such, there is no EANDCB impact of this primary legislation.

2.33 The Government has consulted with the FCA in the preparation of this impact assessment. The FCA has supplied data on the capital requirements, which has allowed us to estimate the overall capital impact on UK investment firms. These

[10] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/authorisations/which-firms-does-the-pra-regulate/2019/designated-firms-list-december-2019.pdf
[11] For more information on Pillar 1, Pillar 2 and Pillar 3 requirements, see the Basel 3.1 section of this impact assessment.

discussions have also considered the impact on UK firms qualitatively, and this informs the analysis below.

2.34 The impact assessment also draws on analysis conducted by the European Commission[12] and the EBA[13] on IFR/IFD, which utilises data from Member States to determine the impact of IFR/IFD on investment firms, the FCA and others. The EBA collected data on a sample of investment firms operating in the EU, including the UK, consisting of 1,199 investment firms. The EBA's analysis was conducted using firms' data on a confidential basis and the results were aggregated. The Government does not have access to the underlying data; however, where possible, the EBA's analysis has been applied to the UK market (see 'Applying EU analysis to the UK' section).

Direct costs

Costs of meeting liquidity requirements

2.35 To assess the impact of liquidity requirements quantitatively, the total liquid capital should be compared to the new liquid capital requirement (1 month FOR). This is the total liquid capital shortfall. The Government explored conducting primary analysis for these costs, but the data is unavailable at this stage.

Liquidity requirements: EU analysis

2.36 Nevertheless, although not analysing the total liquid capital shortfall in absolute terms, the EBA did assess the number of firms likely to have a shortfall. The EBA found that 8% of class 2 (non-SNI) firms and 11% of class 3 (SNI) firms experienced a liquid capital shortfall, with the vast majority of firms holding liquid capital well in excess of liquidity requirements.

Liquidity requirements: applying the EU's analysis to the UK

2.37 In the absence of more granular data, it is possible to scale these results to the UK when combining with data on the distribution of UK investment firms into class 2 and class 3, according to the EBA's analysis. This makes it possible to judge the number of UK investment firms which could experience a liquid capital shortfall, and therefore face additional costs.

2.38 Assuming the UK submission to the sample is representative of the wider UK investment firm market (see 'Assumptions, limitations and considerations' section), 98% of UK investment firms would be class 2 and 2% would be class 3[14]. Extrapolating this out to the full population of non-systemic UK investment firms:

2.39 257 of the 3194 UK investment firms to which this regime will apply will face additional costs to meet the new liquidity requirements. If it was conservatively assumed that the proportion of UK firms in each class was 50% in class 2 and 50%[15] in class 3 and

[12] See European Commission Staff Working Document SWD(2017)481: *Review of the prudential framework for investment firms*.

[13] EBA analysis: Annex to the EBA opinion in response to the European Commission's call for advice with regards to investment firms.

[14] This is the distribution of UK investment firms in the EBA's sample. In reality, it may be expected that the distribution of class 2 and class 3 UK investment firms will be be much closer to an equal proportion in each class.

[15] The FCA assumed a 50/50 split between Class 2 and Class 3 firms in their primary analysis for the cost of capital requirements. This is not necessarily reflective of the settled distribution of Class 2 and Class 3 firms in the final regime.

applied it to the EBA's analysis, it is estimated that the number of UK firms experiencing a liquid capital shortfall to be 304. This is because a greater proportion of firms will be part of class 3; a class where the EBA analysis suggests more firms will have a liquid capital shortfall compared to class 2.

2.40 On the one hand, this impact may be somewhat overstated because one type of asset[16] was excluded as a liquid asset in the EBA's analysis, which will be available in final regime. When this is accounted for, it is likely that fewer firms would face a regulatory liquid capital shortfall.

2.41 On the other hand, the impact of this may be somewhat understated compared to the final regime. This is because the value of the liquid assets is not subject to 'haircuts', meaning their capital requirement is adjusted above the market value to reflect the possibility that the asset may fall in value. The extent to which haircuts change the analysis above depends on future policy decisions, and therefore is likely to be reflected in impact assessments accompanying secondary legislation or FCA rules. The extent to which these nuances have an effect on the final regime are likely to be explored in more detail in their cost-benefit analysis.

Table 2.1: Liquid capital shortfall of UK investment firms by class[17]

	Class 2 (%)	**Class 3 (%)**	**Total**
Investment firms	3127 (97.9%)	67 (2.1%)	3194[18] (100%)
Number of firms experiencing liquid capital shortfall	250	7	257

Reporting and disclosure

2.42 IFR/IFD and the UK regime will include a simplified reporting and disclosure framework for non-systemic (class 2 and 3) firms, which is proportionate to the size and complexity of the investment firm. Class 3 investment firms (small and non-interconnected firms) will further benefit from even greater simplification, as they will only have to comply with a subset of the reporting requirements applicable to other non-systemic investment firms.

2.43 On an ongoing basis, it is expected that this would represent a benefit for the majority of firms as the simplification of reporting allows firms to incur fewer administrative costs. This is amplified by the fact that most firms have reporting procedures in place as a result of the current reporting requirements of the CRDIV package. In contrast, there may be minor one-off costs to tailoring firms' reporting and disclosure procedures to the new regime in the first instance.

Compliance and administration

2.44 The introduction of the new UK regime means that investment firms will face one-off costs from establishing structures to comply with the new framework. Firms may have

[16] 'Trade debtors/fees receivables'
[17] These categorisations are based on EBA analysis and are for illustrative purposes only. These do not represent the final categorisation of UK investment firms under the IFPR.
[18] All UK investment firms, excluding the eight firms that it is expected the PRA will designate as systemically important.

to make changes to risk management systems, update compliance departments and revise contracts with law firms in order to comply with the new regime[19].

2.45 In May 2017, the European Commission held a workshop with select investment firms in which costs of compliance of IFR/IFD were discussed. At that workshop, and in an accompanying survey, some investment firms indicated that individual firms would be exposed to compliance costs in the "EUR tens of thousands"[20]. Whilst this may represent some costs to an indefinite number of firms, it is not certain it will apply to all investment firms. Indeed, a consideration when designing the regime was that the regime should not impose unreasonable compliance burdens on firms. It is therefore hard to assess whether investment firms in the UK will face comparable compliance costs as those estimated in the EU initial assessment.

Familiarisation costs

2.46 In order to comply with the UK regime, firms will need to familiarise themselves with the relevant legislation and the accompanying guidance. Compliance officers will need to familiarise themselves with primary and secondary legislation, as well as FCA rules. Quantifying the familiarisation costs will only be possible once the FCA has finalised its rules.

Policy Benefits

Direct benefits

Capital requirements impact

2.47 Investment firms must hold capital to ensure that they have adequate resources to remain financially viable and perform their services through economic cycles. Whilst this is beneficial from a prudential perspective, the opportunity cost of holding this capital is that investment firms cannot invest capital elsewhere, which would otherwise be beneficial to the real economy.

2.48 To assess the benefits of moving to new capital requirements, it is necessary to:

i. Identify the capital required under the current capital requirements

ii. Identify the change in capital requirements from a given method of calculation under the new regime (i.e. PMC, FOR or K-factor) and aggregate[21]

iii. Calculate the difference between capital required under current requirements and capital required under the new regime.

2.49 The steps above allow us to calculate the benefit to UK investment firms from the change in Pillar 1 capital requirements.

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[19] See European Commission Staff Working Document SWD(2017)481: *Review of the prudential framework for investment firms*

[20] See European Commission Staff Working Document SWD(2017)481: *Review of the prudential framework for investment firms*

[21] See Annex D for a full breakdown of the impact of each method of calculating capital requirements on the overall capital requirement.

Table 2.2: Change in capital requirements

Change in capital requirements	Firms		Capital required		
			Total		Change
	Number	%	Current	Change	
Decrease	1,286	40%	£5,402m	(£1,337m)	(25%)
Increase	1,806	57%	£2,115m	£942m	45%
No change	102	3%	£20m	-	0%
Total	3,194	100%	£7,537m	(£395m) *	(5%) *

*net change *Source: FCA*

2.50 Table 2.2 shows the total non-discounted change in capital requirements for the UK investment firm sector. In moving to the new regime, 1,286 investment firms (40%) experience a decrease in their Pillar 1 capital requirements; 1,806 (57%) experience an increase; and 102 (3%) experience no change.

2.51 In aggregate, Pillar 1 capital requirements are expected to fall by 5%. This means that the total level of Pillar 1 capital required to be held each year by investment firms will be £395 million lower[22].

2.52 The above total capital benefit figure should be considered alongside a number of nuances that may mean the final capital impact on investment firms differs to the result above. Firstly, Table 2.2 shows the impact on Pillar 1 requirements, which itself may differ significantly for different firms. Pillar 2 requirements, which are specific add-ons set by regulators to address firm-specific weaknesses, are still to be confirmed. Where Pillar 1 requirements have gone up for a firm under the new regime, this should reflect the fact that the minimum requirements would now better reflect the risks faced by firms. Therefore, less reliance should need to be placed upon Pillar 2 for capturing those risks in the future. This means that any increase in Pillar 1 requirements for firms may be offset by a decrease in Pillar 2. Indeed, the FCA, like the Bank of England for banking regulation, are committed to not double-counting risks in Pillar 1 and 2.

2.53 It should also be noted that relevant firm data will become more available once the IFPR becomes operational. For example, as firms report more data related to certain business activities, capital requirements relating to certain K-factors will likely increase[23]. As a result, it could be that the total percentage change in capital required compared to the current regime may be lower than anticipated.

2.54 On the other hand, whilst not strictly Pillar 1 and therefore not assessed in this impact assessment, a small proportion of firms who currently have to maintain additional capital requirements under the current regime will no longer need to in the new

[22] Capital often takes the form of debt. This means that lower capital requirements may not mean lower costs for firms as debt will have to be repaid in both option 1 and option 2, and therefore these are not directly relevant EANDCB calculations However, the foregone interest will be an additional benefit (see next section).
[23] In particular, data provided by firms on K-DTF (daily trade flows) and K-COH (client orders handled) is expected to be much higher in the final Regime than in this impact assessment. This is because more information will become available on how these metrics are to be measured by firms.

regime[24]. This is likely to lead to a significant reduction in capital requirement for those firms.

2.55 Finally, the above analysis shows the difference in the minimum level of capital required to be held by investment firms between the current and new regime. In reality, many investment firms will currently be holding capital in excess of their capital requirements (commonly known as "management buffers"). For these firms, the capital surplus from moving to the new minimum capital requirements will be larger than that implied by the data in this impact assessment, should they wish to maintain the same level of management buffer as before[25].

Other capital impact considerations

2.56 Capital cannot be raised at cost price. A significant proportion of capital takes the form of debt and equity, which means investors and lenders would expect a return in the form of interest or dividends.

2.57 In the future, investment firms who face lower capital requirements may need to issue less debt or equity in order to meet their new requirements, compared to the current regime. The rate of interest on this debt would represent an additional saving from not having to make payments on debt that now may not need to be issued. However, whilst there may be a net benefit in total savings for UK investment firms due to the lower aggregate requirements, this may not be the case for all firms. Indeed, Table 1 shows that 57% of firms will not receive this benefit as they will not experience a decrease or no change in their capital requirement.

2.58 For the purposes of the impact assessment, the Government explored quantifying the additional saving resulting from the reduced total cost of capital. However, it was found that the number of variables involved made quantifying this cost impractical at this stage. Specifically, this is due to:

i. There are 3194 non-systemic investment firms in the UK. Each of these firms would receive a different interest rate on their debt, dependent on their perceived creditworthiness.

ii. Each investment firm may issue debt of several different qualities. An investment firm issuing Tier 1 debt would receive a different rate of interest compared to issuing Tier 2 debt, despite being the same firm. It would be difficult to know which quality of debt would apply, and in reality, it is likely to be a mixture.

iii. A significant number of buyers of debt are likely to be international investors. This would represent an economic transfer out of the country rather than economic benefit, and therefore would be out of scope of this impact assessment.

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[24] Some investment firms will no longer have to maintain additional capital requirements in the form of the capital conservation buffer of the Capital Requirements Directive.

[25] For example, Table 2.2 shows the capital required under the current regime and under the new Regime – this is the capital surplus. However, firms may hold capital above that which is currently required, meaning the surplus may be larger than that shown in Table 2.2.

2.59 As a result, the Government has estimated that there would be an additional saving for investment firms for the reduced total cost of capital itself. Whilst this would be difficult to quantify at this stage, it is likely to be a function of the fall in Pillar 1 capital requirements.

More appropriately calibrated prudential requirements

2.60 The primary benefit of the UK regime is that prudential requirements will be more appropriately calibrated to the size, complexity and business activities of investment firms. This alleviates the significant costs to these firms of having to adhere to a prudential framework based on the activities of banks and building societies. As a result, the operating conditions of investment firms should improve, freeing up capital which would otherwise have been used for counterproductive regulatory purposes.

2.61 Confidence in the stability of investment firms should also grow, as firms will be better placed to assess risks and respond to economic stress. In turn, investor sentiment and market stability are also likely to benefit, which will facilitate the access to finance in capital markets.

Assumptions, limitations and considerations

2.62 The substantive estimates of this impact assessment relate to the costs and benefits of the UK prudential regime for investment firms, drawing on analysis for IFR/IFD. The Government has consulted with the FCA to ensure that estimates used are based on the best possible evidence available. However, there are a number of considerations that must be borne in mind that may lead to differences in the impact of the final regime.

2.63 First, as policy decisions are yet to be finalised, it cannot be said for certain the distributions of firms into each 'class' at this stage. This would have an effect on the elements of the analysis, particularly costs of capital and liquidity requirements. A firm in 'class 2' would have different capital requirements to a firm in 'class 3', and consequently a different capital or liquid capital shortfall.

2.64 In the absence of other data, this impact assessment uses the categorisations of UK investment firms in the EBA's analysis. This provides a starting point for assessing UK firms. However, it should be noted that the EBA conducted its survey of firms on a voluntary and best efforts basis. Indeed, firms were to complete or not complete data fields as they wished, and some firms may have not submitted data on metrics that they would have to monitor under the new regime, but not under the current framework. To mitigate these issues, the EBA undertook a series of adjustments – including proxies – and this may have resulted in some level of approximation. As primary data was used to assess the impact of capital requirements, there was an equal split assumed in the categorisations of firms consistent with FCA assumptions.

2.65 The FCA's policy decisions may also impact the costs or benefits for investment firms of the final regime. For example, they may be able to exempt certain firms from aspects of the liquidity requirements, such as haircuts, if they deem it appropriate. This could affect the liquidity requirement of firms and therefore the liquid capital shortfall. However, significant exemptions are not expected to occur across the industry, meaning that this effect may be negligible.

2.66 Finally, the activities of the concerned firms also present a potential risk to the assumptions made in this analysis. For example, it has not assessed how net benefits would change in the event that investment firms change their business models. This

could be driven by wide-ranging and unpredictable factors, which alter the firms' capital and liquidity requirement and therefore their associated costs. Therefore, it has been assumed that firms' business models will continue as at present for the duration of the assessment period.

Small and MicroBusiness Assessment (SaMBA)

2.67 In general, a small firm will still be subject to this regime for the purposes of orderly wind down. This will enable such a firm to retreat from the market in a way that poses minimal harm to other firms, customers or the stability of the market itself.

Consistent with the aim of proportionality, this means that some small firms may fall within scope of prudential requirements for the first time. Indeed, "local firms", who are defined as having starting capital of at least €50,000, were out-of-scope of the CRDIV package but will become in-scope under the IFPR.

2.68 To alleviate the effects of now becoming in-scope, it is expected that the UK's IFPR, which will be introduced through FCA rules, will take a similar approach to the EU's IFR/IFD, which puts in place transitional requirements on a number of firms, including small firms, for five years. This limits the increase in capital requirements until five years after the regime becomes active, thereby giving firms appropriate time to make financial, operational and governance changes to ensure they can meet the new requirements.

Wider Impacts

2.69 There are no wider impacts associated with this measure.

Summary

2.70 This measure imposes a duty on to the FCA to introduce a UK prudential regime for investment firms (IFPR). The UK was instrumental in the introduction of the Investment Firms Regulation and Directive (IFR/IFD) at EU level. Therefore, the UK regime will reflect the same outcomes as the IFR/IFD, while catering for the specificities of the UK market. This impact assessment uses the EU's IFR/IFD scheme as a proxy for potential impacts on UK firms. The exact costs and benefits will be determined when the firm level requirements are introduced by the FCA through their rules.

Implementation of the remaining Basel standards in the UK

Problem Under Consideration

The macroeconomic impact of financial crises

3.1. As seen by the global financial crisis of 2007-09, ensuring the stability of the banking sector is vital to the underlying economy. They provide essential services to the economy as deposit takers, payment facilitators and credit providers.

3.2. During the financial crisis, UK banks made large losses, with some institutions coming close to failure and others requiring recapitalisation by the Government. Lending to the real economy fell sharply, households and businesses cut back on spending and the economy suffered its worst recession since the Second World War. UK output remained significantly lower than suggested by its pre-crisis trend, right up to the covid-19 pandemic.

Drivers of the 2007-08 financial crisis

3.3. A key contributor of the financial crisis in 2007-2008 included the fact that many banks were insufficiently capitalised, with low levels of liquidity and fully loss-absorbing equity capital. As a result, some banks ended up in difficulty and required Government assistance.

3.4. Since the crisis, these vulnerabilities have been addressed by measures to ensure banks are sufficiently capitalised and that capital is of high quality, reducing the need for Government assistance.

3.5. Another contributor was the level of risk that banks associated with the assets they held within their portfolios. In particular, the crisis demonstrated that a range of risks associated with banks' assets were not covered. Additionally, the ways in which risk of loss (or exposure to loss) was estimated by banks was also flawed. In particular, the use of internal models in the calculations of these risk exposures tended to vary significantly across institutions.

Rationale for Intervention

3.6. Prudential regulation ensures banks internalise wider economic costs that stem from the way they carry out their business and into their appetite for risk-taking. By requiring banks to hold sufficient amounts of capital relative to the risks they take on, the likelihood of a banking crisis is reduced. Holding sufficient capital allows banks to absorb unexpected losses and allows them to continue to provide essential credit to the real economy.

3.7. When losses are incurred, the level of capital a bank has will also support investor and depositor confidence without needing to reduce provision of credit.

3.8. In addition, there is a need for governments across jurisdictions to act together. As evident in the 2007-08 financial crisis, a crisis in the banking sector of one jurisdiction can spill over into other jurisdictions. It is therefore vital to raise prudential standards

internationally to reduce the likelihood of a systemic crisis, promoting confidence in the resilience of the financial sector.

3.9. When consistently applied across jurisdictions, improved prudential standards also help avoid regulatory arbitrage, where banks seek to operate in those jurisdictions where the regulatory burden is lowest.

3.10. The high economic cost of banking crises, as well as the need for consistent and improved prudential standards are unlikely to be reduced without government intervention.

Policy Objective

The role of international standards

3.11. International regulatory co-ordination is not new. However, since the financial crisis, there has been a concerted international effort to address key drivers of financial instability, particularly in relation to the levels of capital and liquidity held by banks. This has led to improvements in the identification and measurement of risks to which banks are exposed to, including associated calculations of risk-weighted assets (RWAs).[26]

3.12. In an increasingly global world, harmonised standards are critical to improving the resilience of the global banking system and encouraging a predictable and transparent regulatory environment for internationally active banks.

3.13. For internationally active and systemically important banks, these standards are set by the Basel Committee on Banking Supervision (BCBS), of which the UK is a member.

3.14. The initial Basel Accord (Basel I) was agreed in 1988 and introduced a set of minimum capital requirements for banks. A revised version was finalised in 2004 (Basel II), introducing a three-pillar approach: Pillar I ‘minimum capital requirements’, which sets out standard rules to calculate minimum capital requirements for credit, operational and market risk; Pillar II ‘supervisory review’, which provides tools for national supervisors to use within their jurisdictions; and Pillar III ‘market discipline’, which complements the first two pillars by requiring banks to disclose information that enable participants to gauge their financial resilience.

Basel III standards

3.15. The BCBS agreed an initial wave of Basel III standards in December 2010 in the wake of the financial crisis. In the period between 2010 and 2017, the BCBS finalised the Basel III package, which included: improvements to the calculation of RWAs; introducing a leverage ratio requirement; additional capital buffers for systemically important banks; developing an enhanced Pillar 2 approach for assessing interest rating risk in the banking book; revisiting the large exposures regime; and updating Pillar 3 disclosure requirements.

[26] Risk-weighted assets (or RWA) is a bank’s assets or off-balance sheet exposures, weighted according to risk

3.16. The different standards that make up the consolidated Basel III framework are set out in the Figure 3.1 below in chronological order.

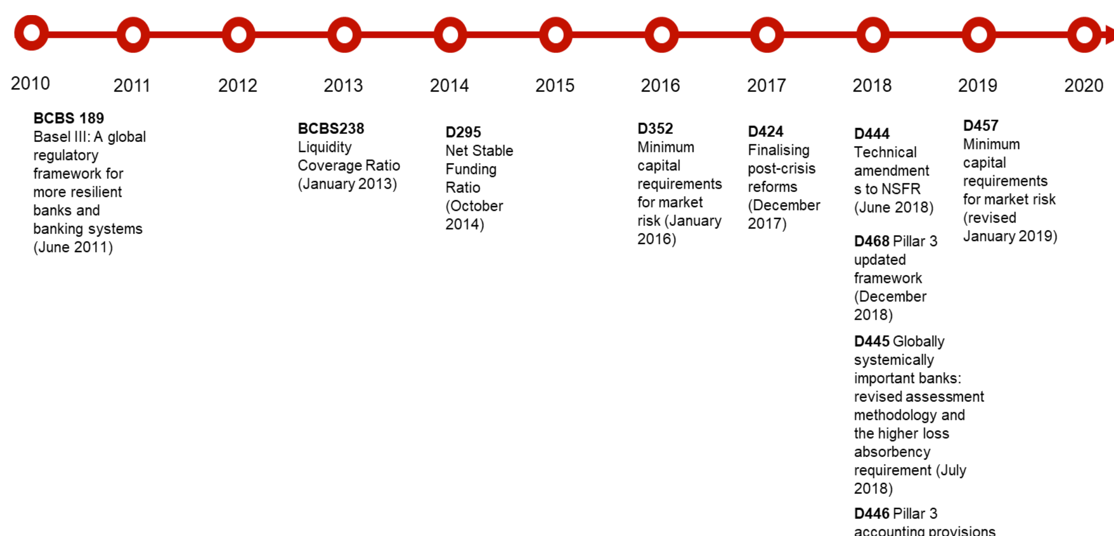

Figure 3.1: Banking standards agreed and published by the Basel committee since 2010

Implementation of Basel III in the UK

3.17. The European Commission implemented the Basel III reforms agreed in December 2010 primarily through the CRDIV package of reforms and the Capital Requirements Regulation (575/2013) (CRR).

3.18. The majority of the Basel III reforms finalised between 2010 and 2017 are being implemented through the 2nd Capital Requirements Regulation (CRRII), and the 5th Capital Requirements Directive (CRDV). Most of the remaining provisions of CRRII will apply in the EU on 28 June 2021. As this date is after the end of the transition period, CRRII will not have direct effect in the UK or form part of the retained legislation at the end of the transition period. The Government is therefore taking powers through the Financial Services Bill to enable the introduction of updated prudential rules for banks in the UK.

3.19. The Financial Services Bill represents the first time the UK Parliament will have a say in the implementation of prudential standards in the UK, other than under s2.2 of the European Communities Act. Many of the previous Basel standards and recommendations have been codified in EU law (which subsequently applied or was implemented in the UK) rather than being legislated for by UK parliament.

3.20. CRR II will also be part of the general body of standards against which the UK will be assessed by the EU for the purposes of various equivalence provisions in EU legislation, most notably those under CRR itself, but also under other associated equivalence provisions like Article 47 of MIFIR. Most Basel 3.1 revisions are not included in CRRII or CRDV and have not yet been legislated for in the EU. As the UK has now left the EU, the Government intends to legislate to implement these most recent revisions to the Basel standards through the Financial Services Bill.

3.21. Most Basel 3.1 revisions are not included in CRRII or CRDV and have not yet been legislated for in the EU. As the UK has now left the EU, the Government intends to legislate to implement these most recent revisions to the Basel standards through the Financial Services Bill.

The aim of the Basel and CRR measures in the Financial Services Bill

3.22. The aim of this primary legislation is to ensure that the UK has the full set of powers necessary to introduce updated prudential rules for banks in the UK.

3.23. The overall aim of updating the UK's prudential rules is three-fold: i) to reduce further the risks in the banking sector and thereby reduce the reliance on taxpayers' money or other extraordinary public financial support in case of a crisis, ii) in implementing these standards, the UK intend to play its part in ensuring the resilience of the global financial system, and iii) to enhance the ability of institutions to channel adequate funding to the economy.

3.24. The full impact of this legislation will be determined by key policy choices as will be identified through the development of regulator rules. A cost-benefit analysis will support consultations on these rules to inform policy choices in due course.

Description of Options Considered

3.25. There are two broad options. It is discussed below what each option means in turn.

3.26. **Option 0: Do Nothing**. As set out above, the UK has already implemented a number of the Basel measures through the CRR. Under this option, the regulators will have capacity to introduce some Basel 3 and 3.1 changes using their existing powers under the FSMA, but will be significantly constrained in introducing some key measures including revisions to the approaches available to measure credit risk, operational risk, CVA risk and market risk.

3.27. In this scenario, the UK will not have met its international commitment to "full, timely and consistent" implementation of the Basel standards, and would fail to keep up with outstanding elements of international post-crisis reform, designed to reinforce financial stability, restore investor confidence and allow institutions to play their fundamental role in supporting economic recovery.

3.28. In addition, by 'doing nothing', there is a risk that non-implementation could affect the UK's prospects of obtaining positive equivalence assessments in a number of areas, affecting cross-border trading.

3.29. This is the current baseline and the counterfactual scenario against which all other options are assessed. The impact of the assumptions made in the counterfactual and their impact on the overall results is discussed below.

3.30. **Option 1 (preferred option):** Take powers in the Financial Services Bill to enable the introduction of updated prudential rules for credit institutions in the UK. Under this option, the Financial Services Bill will enable the "full, timely and consistent" implementation of Basel III reforms as well as enhance the prospects of the UK being found equivalent under a number of provisions.

3.31. More specifically, primary legislation will provide the ability to amend retained EU legislation, in this instance the CRR and delegate to the relevant authorities both regulation-making and rulemaking powers.

Policy Outline

The aim of the legislation

3.32. The primary legislation (to which this impact assessment related) would introduce new powers to enable changes to be made to prudential banking regulations that were retained by the UK under the EU Withdrawal Act 2018 (EUWA). The aim of this primary legislation is to ensure that the UK has the full set of powers necessary to introduce updated prudential rules for banks in the UK.

3.33. In its current form, the CRR applies to all banks, building societies, credit institutions and PRA designated firms.

3.34. With regard to Basel III reforms published between December 2010 and December 2017, the UK will seek to take powers to delegate to the regulators the subject areas contained within CRRII, while providing flexibility to tailor the actual detail of these subject areas to the UK.

3.35. In the primary legislation the Government will take powers to modify the retained EU legislation as contained within the CRR to: 1) ensure alignment with international Basel standards, and 2) to ensure UK firms can compete effectively internationally and ensure proportionality for smaller firms.

3.36. The primary legislation does not specify the detail of these changes, as the technical changes which are required will be determined through subsequent secondary legislation and regulator rules. Detailed impact assessments will accompany these.

3.37. It is not possible (or appropriate) to provide a meaningful estimate of the EANDCB figure for validation at the primary legislation stage. This assessment uses illustrative examples where possible and available evidence from published data and research.

Background – the Basel framework

3.38. The Basel III framework is a central element of the Basel Committee on Banking Supervision's (BCBS) response to the global financial crisis. It addresses a number of shortcomings in the pre-crisis regulatory framework and provides a foundation for a resilient banking system that will help avoid the build-up of systemic vulnerabilities. The framework will allow the banking system to support the real economy through the economic cycle.

3.39. Basel II introduced what is known as the three-pillar approach in 2004. The three pillars relate to minimum capital requirements, supervisory review, and market discipline. These are set out in more detail below.

Pillar 1: Minimum capital requirements

3.40. The Basel Committee on Banking Supervision (BCBS) sets the guidelines around risk-weighted assets (RWA). An RWA is a bank's asset or off-balance sheet exposure, weighted according to risk. RWAs are used to determine the minimum amount of capital that must be held by banks and other financial institutions in order to reduce the risk of insolvency. The capital requirement is based on a risk assessment for each type of bank asset/exposure.

3.41. Minimum capital requirements represent the ratio of bank's capital to a bank's RWA, as demonstrated by the following equation:

$$Minumum\ capital\ requirements\ (6\%) = \frac{regulatory\ capital}{risk\ weighted\ assets}$$

3.42. As per the initial Basel 3 reforms, banks must hold enough capital, such that the ratio of capital to its RWAs always equals 6%.

3.43. Banks may be exposed to losses resulting from a range of different types of risks including credit risk (the risk that a counterparty – consumer or corporate – will fail to meet its obligations in accordance with agreed terms), operational risk (the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events and market risk (the risk of losses arising from movements in market prices).

3.44. Credit risk tends to be the main driver of loss, followed by operational risk and market risk. However, as the latest Basel standards recognise, there are a range of further risks that banks are also exposed to and need to be captured. These include counterparty credit risk (the risk that one of those involved in a transaction defaults on their contractual obligation) and relatedly credit valuation adjustment risk ((the risk that the counterparty to a transaction could default before the final settlement of the transaction's cash flows).

3.45. To measure these risks, the Basel standards offer different approaches. Some are more prescriptive, whereby Banks apply a methodology that is prescribed by the Basel standards and regulators on what level of exposure to loss should be attributed to certain asset categories. These are generally known as Standardised approaches. Another approach, allows Banks to develop their own models to assess the level of risk associated with different assets, known as an internal models approach. The justification for allowing the use of internal models was to increase the level of risk sensitivity in the calculation of RWAs. This means that banks do not hold more capital than what is necessary, so that capital, rather than held by banks can be invested and lent out to support activities in the real economy. To use internal models, banks must meet specific standards in relation to their models, policies and procedures, data integrity and validation in order to qualify. These are overseen by the supervisor who grants approval for their use.

Pillar 2: Supervisory Review

3.46. This second pillar reinforces the role of supervisors and national authorities in ensuring that banks within their jurisdiction have adequate capital to support the risks in their

business and also promote better risk management techniques in monitoring and managing risks.

3.47. Supervisory evaluation is intended to generate active dialogue between banks and supervisors so that when excessive risks, insufficient capital or deficiencies are identified, prompt and decisive action can be taken to reduce risk, address deficiencies or restore capital.

Pillar 3: Market Discipline

3.48. Pillar 3 recognises that market discipline has the potential to reinforce capital regulation and other supervisory efforts to promote safety and soundness in banks and financial systems.

3.49. The aim of this pillar is to reinforce Pillar 1 and Pillar 2, by requiring banks to provide meaningful information about common key risk metrics to market participants. It reduces information asymmetry and helps promote comparability of banks' risk profiles within and across jurisdictions.

3.50. Such disclosure requirements enable market participants to access key information relating to a bank's regulatory capital and risk exposures in order to increase transparency and confidence about a bank's exposure to risk and the overall adequacy of its regulatory capital.

3.51. It thereby imposes strong incentives on banks to conduct their business in a safe, sound and efficient manner. It can also provide a bank with an incentive to maintain a strong capital base as a cushion against potential future losses arising from its risk exposures.

Basel III reforms

Initial Basel III reforms

3.52. The Basel III reforms that were agreed in December 2010 sought to strengthen the existing provisions of the Basel II framework in a number of areas, notably, the quality and quantity of capital and risk coverage. In particular, the BCBS tightened requirements for different types of capital that banks are required to hold against RWAs. The minimum capital ratio must be with 6.0% Tier 1 capital. Tier 1 capital consists of Common Equity Tier 1 (CET1) and Additional Tier 1 (AT1) capital. CET1 is the predominant component of the Tier 1 capital and must be at least 4.5% of the total Tier 1 requirement at all times. The remainder, 1.5% can be met with AT1 capital, unless the firm would like to use only CET1 for the full 6% Tier 1 requirement.

3.53. CET1, consists mainly of common shares issued by the bank, retained earnings and/or other income and disclosed reserves, whereas AT1 consists of share premiums or subordinated debt.

3.54. The key property of Tier 1 capital is its ability to absorb losses and therefore help a bank withstand times of stress. Banks will typically use AT1to absorb losses only after CET1 resources have reached low levels.

3.55. The initial Basel III reforms also introduced some entirely new prudential requirements, notably, capital buffers, the leverage ratio and liquidity requirements. The reforms were intended to apply at both the micro-prudential level (affecting individual firms) and the macroprudential level (affecting the financial system as a whole).

3.56. The European Commission implemented the Basel III reforms agreed in December 2010 primarily through the CRDIV package of reforms. These reforms are directly applicable in the UK.

Remaining Basel III reforms

3.57. The majority of the Basel III reforms finalised between 2010 and 2016 are being implemented through CRRII and CRDV. Only those provisions that apply before the end of the Transition Period will form part of retained EU law

3.58. Further, as outlined in paragraph 3.21, a number of Basel reforms introduced after 2017, known as Basel 3.1 have also not yet been legislated for in the EU or the UK. Therefore, without further legislation to amend retained Capital Requirements Regulation, they will not apply in the UK.

3.59. The UK intends to legislate through the Financial Services Bill to enable implementation of these standards in the UK.

3.60. The rest of this section sets out the Basel III reforms that will be in scope of the FS Bill.

Setting a standard for the Net Stable Funding Ratio (NSFR)

3.61. Before the financial crisis, institutions made use of excessive amounts of short-term wholesale funding to finance their long-term activities. When short-term funding became unavailable, institutions were either forced to request emergency liquidity assistance from central banks or engage in 'fire sales' of assets, triggering a downward spiral in prices and eroding their liquidity positions, with the ultimate consequence of driving a number of them into insolvency. The Basel Committee published the Net Stable Funding Ratio standard in 2014 to ensure that long-term assets can be adequately met with a diversity of stable funding instruments (liabilities) under both normal and stressed conditions. It expected its members to introduce the NSFR as a minimum standard by 1 January 2018.

3.62. Further, in 2018, the BCBS released an amendment to this standard, which aims to provide greater flexibility in the treatment of extraordinary central bank liquidity-absorbing monetary policy operations. It does this by allowing reduced required stable funding factors for claims on central banks with a maturity of more than six months, subject to a floor of 5%. The technical amendment is expected to be applicable from 1 January 2023.

Capital requirements for equity investment in funds

3.63. In October 2011, the Financial Stability Board (FSB) announced the creation of five workstreams to strengthen the oversight and regulation of shadow banking. This included a workstream on banks' interactions with shadow banking entities. The BCBS

agreed to review the risk-based capital requirements for banks' exposures to funds and in December 2013, the BCBS finalised a standard on the treatment of equity investments in funds. The standard concerns the calculation of capital requirements for banks' equity investments in funds that are held in their banking book. The BCBS' aim was to clarify the existing treatment and to achieve a more internationally consistent and risk-sensitive treatment of these exposures.

Large Exposures

3.64. The large exposure requirements set out in the Basel framework is intended to protect firms from significant losses caused by the sudden default of a large individual counterparty or a group of connected counterparties. The framework was designed so that the maximum possible loss a firm could incur if such a default were to occur would not endanger the firm's ability to operate. In April 2014, the BCBS published a final standard (BCBS283) setting out its supervisory framework for measuring and controlling large exposures. The framework includes a general limit applied to all of a bank's exposures to a single counterparty or a group of connected counterparties, set at 25% of a bank's tier 1 capital. A tighter limit of 15% of tier 1 capital applies to exposures between Globally Systemic Important Banks (G-SIBs).

Counterparty credit risk

3.65. Weaknesses in risk management practices associated with derivatives were revealed by the financial crisis. This led the Basel Committee on Banking Supervision (BCBS) to include a significant strengthening of its framework for counterparty credit risk (CCR) for securities financing transactions (SFTs) and both over-the-counter (OTC) and centrally cleared derivatives in its Basel III response to the crisis. Counterparty credit risk (CCR) is the risk to a firm that a counterparty to a transaction might not perform its contractual obligations before the transaction's cash flows are settled. Banks are required to identify their transactions that expose them to counterparty credit risk and calculate a related capital requirement. In March 2014, the BCBS published a standardised approach for the calculation of the exposures value of derivatives contracts (SA-CCR) (BCBS279). The SA-CCR is a more risk-sensitive approach than existing calculation methods - known as the Current Exposure Method (CEM), and the Standardised Method (SM) - and will replace those approaches. The BCBS' aim was to address the problem that these existing approaches did not recognise appropriately the risk reducing nature of collateral in the exposures, did not reflect the levels of volatility experienced in the financial crisis and did not recognise netting benefits appropriately.

Capital requirements for bank exposures to central counterparties (CCPs)

3.66. In the wake of the financial crisis, the G20 leaders agreed that all standardised derivatives contracts should be traded on exchanges or electronic trading platforms and cleared through central counterparties (CCPs). As counterparties to the buyers and the sellers, CCPs guarantee the terms of a trade — even if one party defaults on the agreement. CCPs bear the lion's share of the buyers' and sellers' credit risk when clearing and settling market transactions. The BCBS released its final policy framework

for the capital treatment of bank exposures to CCPs in April 2014. Among other things, this framework introduced preferential capital treatment for trade exposures to qualifying CCPs (QCCPs). These are CCPs that are compliant with standards set by the Committee on Payments and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO). Almost all CCPs are QCCPs.

Pillar 3 Disclosures

3.67. Since Basel II, the BCBS have released four updates to the disclosure framework, in 2015, 2017 and two in 2018.

3.68. In January 2015, the BCBS published revised Pillar 3 disclosure requirements for credit risk, counterparty credit risk, securitisation, market risk, operational risk and interest rate risk in the banking book. BCBS309 also sets out five guiding principles for banks' Pillar 3 disclosures, together with guidance on how to apply the principles.

3.69. In March 2017, the BCBS issued further revisions to Pillar 3 disclosure requirements, consolidating existing and new requirements into one framework. This covers the composition of capital, the leverage ratio, the liquidity ratios, the indicators for determining globally systemically important banks, the countercyclical capital buffer, interest rate risk in the banking book and remuneration. The update also introduced, key prudential metrics to provide more information to investors and reflects wider regulatory reforms, including the total loss-absorbing capacity (TLAC) regime for globally systemically important banks and the revised market risk framework published by the Committee in January 2016.

3.70. In August 2018, the BCBS published a technical amendment on additional Pillar 3 disclosure requirements for those jurisdictions implementing an expected credit loss (ECL) accounting model (otherwise known as IFRS9) as well as for those adopting transitional arrangements for the regulatory treatment of accounting provisions. The amendment is intended to provide users with disclosures that fully reflect any transitional effects for the impact of expected credit loss accounting on regulatory capital, as well as to provide further information on the allocation of accounting provisions in the regulatory categories of general and specific provisions for standardised exposures during the interim period.

In December 2018, the BCBS subsequently issued further updates to the Pillar 3 framework standards[27]. This update reflects the finalisation of the Basel reforms in December 2017 (discussed below as part of Finalising Post Crisis Reforms). In addition, the updated framework sets out new disclosure requirements on asset encumbrance and, when required by national supervisors at the jurisdictional level, on capital distribution constraints.

[27] Revised Pillar III Requirements, Basel Committee (2019): https://www.bis.org/bcbs/publ/d455.htm

Other International Standards

The prudential treatment of banks' investments in holdings of Total Loss Absorbing Capacity (TLAC)-qualifying instruments

3.71. CRRII also contains revisions to the CRR that introduce a minimum harmonised TLAC requirement for Globally Systemic Important Institutions (or G-SIIs, the EU term for G-SIBs) to reflect the Financial Stability Board (FSB)'s TLAC standard. In the absence of adequate crisis management and resolution frameworks, governments around the world were forced to step in and financially support banks during and following the financial crisis. Since then, significant steps have been taken through the introduction of resolution regimes to minimise the risk to depositors, the financial system and public funds of failing banks. One tool of resolution regimes is "bail-in" which is used write down and/or convert into equity the claims of shareholders and unsecured creditors to absorb losses and recapitalise a firm (or its successor). This ensures that investors and shareholders, and not the taxpayer, absorb losses when a firm fails. The TLAC standard sets a minimum requirement for own funds and eligible liabilities that G-SIBs need to hold.

Finalising Post crisis reforms

3.72. Finalising Post Crisis Reforms (FPCR) finalises the package of Basel III measures and was published by the BCBS in December 2017. Where many of the initial Basel III reforms focused on the level and quality of regulatory capital and liquidity held by banks, FPCR focuses on the second half of the minimum capital ratio i.e. on the calculation of RWAs.

3.73. During the crisis calculations of RWAs varied significantly across institutions, which resulted in a wide range of stakeholders losing confidence in risk-weighted capital ratios reported by banks. The reforms contained in FPCR seek to restore credibility to the calculation of RWAs by improving comparability and transparency of banks' risk-based capital ratios, without significantly increasing capital requirements at a global level.

3.74. The subsequent sections set out the key changes proposed by the BCBS in FPCR and their rationale.

Changes in relation to standardised approach to credit risk

3.75. As previously mentioned, credit risk accounts for the bulk of most banks' risk-taking activities and hence their regulatory capital requirements. The standardised approach is used by the majority of banks around the world, including in non-Basel Committee jurisdictions.

3.76. The BCBS revisions to the standardised approach for credit risk enhance the regulatory framework by:

- improving its granularity and risk sensitivity across different types of exposures. For example, the Basel II standardised approach assigns a flat risk weight to all residential mortgages. In the revised standardised approach mortgage risk weights depend on the loan-to-value (LTV) ratio of the mortgage;

- reducing mechanistic reliance on credit ratings, by requiring banks to conduct sufficient due diligence, and by developing a sufficiently granular non-ratings-based approach for jurisdictions that cannot or do not wish to rely on external credit ratings; and
- providing the foundation for a revised output floor to internally modelled capital requirements (to replace the existing Basel I floor) and related disclosure to enhance comparability across banks and restore a level playing field.

3.77. These changes will affect all firms subject to capital requirements regulations.

Changes in relation to Internal Ratings Based (IRB) approach to credit risk

3.78. The financial crisis highlighted a number of shortcomings related to the use of internally modelled approaches for regulatory capital, including the IRB approaches to credit risk. These shortcomings include the excessive complexity of the IRB approaches, the lack of comparability in banks' internally modelled IRB capital requirements and the lack of robustness in modelling certain asset classes.

3.79. To address these shortcomings, the BCBS has made the following revisions to the IRB approaches:

- removed the option to use the advanced IRB (A-IRB) approach for certain asset classes;
- adopted "input" floors (for metrics such as probabilities of default (PD) and loss-given-default (LGD)) to ensure a minimum level of conservativism in model parameters for asset classes where the IRB approaches remain available; and
- provided greater specification of parameter estimation practices to reduce RWA variability.

3.80. These changes will mainly affect those firms subject to CRR that also use internal models.

Changes to the Credit Valuation Adjustment (CVA) risk framework

3.81. Credit valuation adjustment risk is the risk of loss on a portfolio of assets that occurs as a result of a deterioration in the credit rating of the counterparty, with which a transaction is being made.

3.82. The initial phase of Basel III reforms introduced a capital charge for such risk – known as CVA risk. This was a major source of losses for banks during the global financial crisis, exceeding losses arising from outright defaults in some instances.

3.83. As part of FPCR, the BCBS has made some revisions to the framework, including:

- enhancing its risk sensitivity: The exposure to loss resulting from CVA risk is dependent on counterparty credit spreads and market risk factors that influence the value of derivatives. For example, fluctuations in the interest rate associated with derivatives contracts can dictate the value of the contract, which would be accounted for in CVA risk. The new framework now recognises and incorporates such market risk factors, thereby introducing more risk-sensitivity;

- strengthening its robustness: by simplifying the approaches available to a standardised and basic approach, with an alternative simplified approach for banks with a relatively small portfolio of derivatives. They remove the option of an internally modelled approach entirely, due to the challenges in modelling CVA risk robustly;
- improving its consistency: by making it more consistent with approaches used in the revised market risk framework. CVA risk is a form of market risk as it stems from changes in changes in market prices which affect the value of a banks' portfolio and subsequently the exposure to a counterparty.

3.84. These changes will affect all firms subject to capital requirements regulations. However, the scale of the impact will depend largely on a firm's business model and its portfolio of assets.

Changes to the operational risk framework

3.85. The financial crisis highlighted two main shortcomings with the existing operational risk framework. First, capital requirements for operational risk proved insufficient to cover operational risk losses incurred by some banks. Second, the nature of these losses – covering events such as misconduct, and inadequate systems and controls – highlighted the difficulty associated with using internal models to estimate capital requirements for operational risk.

3.86. The BCBS has streamlined the operational risk framework. The advanced measurement approaches (AMA) for calculating operational risk capital requirements (which are based on banks' internal models) and the existing three standardised approaches are replaced with a single risk-sensitive standardised approach to be used by all banks.

3.87. The new standardised approach for operational risk determines a bank's operational risk capital requirements based on two components: (i) a measure of a bank's income; and (ii) a measure of a bank's historical losses. Conceptually, it assumes: (i) that operational risk increases at an increasing rate with a bank's income; and (ii) banks which have experienced greater operational risk losses historically are assumed to be more likely to experience operational risk losses in the future.

3.88. These changes will affect all firms subject to capital requirements regulations.

Changes to the output floor

3.89. The Basel II framework introduced an output floor based on capital requirements that used the Basel I framework. That floor was calibrated at 80% of the relevant Basel I capital requirements. Implementation of the Basel II floor has been inconsistent across countries, partly because of differing interpretations of the requirement and also because it is based on the Basel I standards, which many banks and jurisdictions no longer apply as they have updated their framework to reflect the latest Basel III standards. In the UK, such an output floor has not yet been applied because no banks are on the Basel I framework anymore.

3.90. The Basel III reforms replace the existing Basel II floor with a revised floor that places a limit on the regulatory capital benefits that a bank using internal models can derive relative to the standardised approaches. In effect, the output floor provides a risk-based backstop that limits the extent to which banks can lower their capital requirements relative to the standardised approaches. This helps to maintain a level playing field between banks using internal models and those on the standardised approaches.

3.91. The output floor aims to support the credibility of banks' risk-weighted calculations and improve comparability of disclosures. Under the revised output floor, banks' risk-weighted assets must be calculated as the higher of: (i) total risk-weighted assets calculated using the approaches that the bank has supervisory approval to use in accordance with the Basel capital framework (including both standardised and internal model-based approaches); and (ii) 72.5% of the total risk-weighted assets calculated using only the standardised approaches.

3.92. These changes will mainly affect those firms subject to CRR that also use internal models. The scale of the impact will depend on difference between a firm's calculation of its RWAs according to their internal models and when using standardised approaches.

3.93. The implementation date for FPCR is 1 January 2023. However, the output floor will be phased-in from 2023 to 2028 (gradually ramping up to 72.5%).

Minimum capital requirements for Market Risk

3.94. Many banks hold portfolios (or collections) of traded instruments which they either trade with other financial institutions regularly to generate profits or hold in the hope that the value of the instrument increases. For example, they may choose to hold foreign currency such as the US dollar, which they trade or sell when the value increases to generate additional profit for the business.

3.95. These portfolios – referred to as trading books – are exposed to market risk, or the risk of losses resulting from changes in the prices of instruments such as bonds, shares and currencies. Banks are required to maintain a minimum amount of capital to account for this risk.

3.96. An important source of losses during the financial crisis was the build-up of risk that occurred in the trading book. A main contributing factor was that the capital framework for market risk did not capture some key risks.

3.97. As a stop-gap response, in July 2009 the Committee introduced the Basel 2.5 framework to help improve the framework's risk coverage and increase the overall level of capital requirements, with a particular focus on trading instruments exposed to credit risk (including securitisations[28]).

3.98. In January 2016, the BCBS published the revised framework for market risk (the fundamental review of the trading book — FRTB). This was a comprehensive review

[28] Securitisation is a way of transferring assets and risk to investors and generate funding for more assets. It does so by merging or pooling various financial assets into one financial instrument that can then be marketed and sold to investors.

of the prudential rules for market risk. The revisions seek to address the deficiencies in the design and calibration of the market risk internal models and standardised approach.

3.99. In January 2019, the Committee revised the framework to address outstanding design and calibration issues of the 2016 framework and to provide further clarity to facilitate its implementation. It is this 2019 framework that is include in the scope of Basel 3.1. The revisions it introduces include:

i. *Further refinements to the boundary of the banking book and the trading book:* The January 2019 revision clarifies the exposures that should be subject to market risk capital requirements, this was designed to prevent regulatory arbitrage between the banking book and the trading book.

ii. *Further refinements to the internal models approach:* Following the January 2016 publication, significant implementation challenges were identified in relation to the internal models approach – in particular, the design of the profit and loss attribution test, which is one of two regulator-set tests that a firm's trading desks must pass to qualify for the use of the internal models approach for market risk. In addition, it was found that certain risk factors couldn't be as easily modelled as thought, which led to higher impact from implementing the revisions than was anticipated. The 2019 revisions do not change the overall structure of the internal model's framework but introduce targeted changes to address these issues. They include:

- overhauling the design of the profit and loss attribution test to better differentiate between well and poorly performing models.
- Targeted changes to address the higher than expected impact of non-modellable risk factors (NMRFs).

iii. *Further refinements to the standardised approach:* The BCBS found that the implementation and impact of the revised standardised approach led to estimations of losses that were too high relative to the actual risk. This has consequential impacts for the level of capital firms are expected to hold against those estimated losses. In addition, the BCBS identified a number of areas where the approach could be simplified to reduce its operational burden*:*

- The revisions better align the treatment (and therefore the capital requirements) of foreign currency positions, options and index instruments with the associated risks.
- Risk weights are lowered by 30% for general interest rate risk and by 50% for FX risk.
- Banks with relatively small or simple trading portfolios may continue to use a recalibrated Basel 2.5 standardised approach, subject to supervisory approval.

Costs and Benefits

Methodology

3.100. The Government has assessed the relative costs and benefits of Policy Option 1 – taking powers to enable the introduction of updated prudential rules for credit institutions in the UK – against a baseline of not making changes to the existing UK prudential framework.

3.101. As stated above, it has not been possible to provide a meaningful estimate of the EANDCB costs at the primary legislation stage. This assessment uses illustrative examples where possible and available evidence from published data and research.

3.102. The assessment takes into account evidence from on-going analysis by the Bank of England and the PRA, as well as drawing on studies produced by the BCBS for assessing the impact of Basel 3.1 at a global level. All estimates are indicative only, and highly sensitive to underlying assumptions.

3.103. Several independent studies have assessed the consequences of stronger capital and liquidity regulation in terms of their long-term impact on economic output. This includes

3.104. the 2010 BCBS report "Assessment of the long-term economic impact of stronger capital and liquidity requirements", often referred to as the LEI study29.

3.105. The LEI study concluded that there are long-term net benefits of a more financially resilient banking system, but observed that the incremental net benefits of reducing the probability of banking crises gradually decline (and become negative) once they exceed a certain level.

3.106. A Bank of England cost-benefit analysis conducted by Brooke et al (2015)30 , examined the macroeconomic impact of higher bank capital requirements in a UK context. Similarly, to the LEI, Brooke et al recognised a trade-off between banks' financial resilience and potential economic output, and identified an optimal system-wide Tier 1 capital ratio in the UK of between 10% and 14%. This range is used as a benchmark to assess the likely impact of Basel 3.1 implementation in the UK.

3.107. Limitations to the conclusions able to be made at this stage include:

i. Baseline assumptions do not take into account other policy programmes that are due to be implemented but not yet in effect. This includes the EBA's IRB model repair programme31, and the Prudential Regulatory Authority's proposed changes to the risk-weighted capital requirements in relation to residential mortgage portfolios. In particular, the IRB repair programme should lead to improvements in modelling practices and bring about the desired consistency the

[29] An assessment of the long-term economic impact of stronger capital and liquidity requirements, Basel Committee on Banking Supervision, August 2010: https://www.bis.org/publ/bcbs173.pdf

[30] Brooke et al (2015), Bank of England, Measuring the macroeconomic costs and benefits of higher UK bank capital requirements : https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-paper/2015/measuring-the-macroeconomic-costs-and-benefits-of.pdf?la=en&hash=9E3312E32D26EC1F02E25CB2F075356B484F0242

[31] European Banking Authority (2019) https://eba.europa.eu/eba-publishes-report-on-progress-made-on-its-roadmap-to-repair-irb-models

Basel standards aim to achieve. The PRA's proposed changes would have notable impacts on the measurement of credit risk.

ii. The UK has already implemented a leverage ratio requirement and has introduced standards on securities financing transactions (SFTs). Therefore, estimates of the impact of new Basel 3.1 standards in the UK are not directly comparable with other Basel members' forecasts.

iii. The final result on the UK will depend on how the UK exercises national discretions and other implementation options that are available within the Basel 3.1 standards.

3.108. Detailed analysis will follow alongside regulator rules, which will contain the detailed Basel standards. The primary legislation to which this IA pertains will ensure that the UK has the full set of powers necessary to enable changes to domestic legislation to be made.

What Basel ought to achieve

3.109. The studies cited above highlight the long-term costs to the economy where banks' resilience is either too low or too high, relative to risks that the banking sector is exposed to. The initial Basel 3 reforms focused on strengthening resilience in light of lessons learned during the last financial crisis.

3.110. Basel 3.1 is instead focussing on restoring credibility in the measurement of RWA, and optimising the allocation of capital across risks accordingly – the aim of the BCBS was not to significantly increase the level of capital held by banks globally.

Economic benefits

Reduction in the probability of banking crisis

3.111. The LEI study identifies that the main benefit of a stronger financial system is the reduction in the probability of banking crisis and subsequent impact on loss of national output. Another benefit is the reduction in the amplitude of fluctuations in output during non-crisis periods.

3.112. The LEI study found that, in any given country, a banking crisis occurs on average 20-25 years, i.e. the average annual probability of a banking crisis is about 4-5%. The LEI points also to evidence that banking crises result in large losses in output relative to trend and are long lasting after the crisis has occurred. Brooke et al (2015) build on this and cite several studies that estimate the economic costs of banking crises in terms of foregone GDP. A summary of these studies is provided in Figure 3.2 below.

Study	Peak loss (% GDP)	Long-run impact (% GDP)
Barrell et al (2009)	6	3
Cecchetti et al (2009)	9	N/A
Cerra and Saxena (2007)	8	7
IMF (2009)	10	10
LEI study (2010a)	9	6
Romer and Romer (2015)	4	3
Brooke et al (2015)	**5**	**4**

Figure 3.2: Summary of literature on costs of crises, Source: Brooke et al (2015)

3.113. Brooke et al (2015) suggest that the average impact of a crisis on the level of GDP six years after the crisis, relative to its pre-crisis trend is 4% for a generic advanced economy.

3.114. Further, based on analysis from the US and UK demonstrating that GDP growth rates have remained below their respective paths of trend GDP, Brooke et al, assume that crises have permanent effects.

3.115. Both the LEI study and Brooke et al use this to understand the relationship between higher capital and liquidity requirements and a banking crisis, and to derive a probability of a banking crisis for different levels of capital ratios. They use analysis of the severity of previous banking crisis on loss of output to understand the nature of avoiding such crises.

3.116. The LEI identifies that the incremental benefits of reducing a banking crisis declines at the margin, with significant decrease in the probability of a crisis where risk-weighted capital is increased from a lower base for example from 7% to 8%, compared with an increase from 10% to 11%. Intuitively, the further away banks are from insolvency, the lower the marginal benefit of additional protection.

Impacts on the Government's fiscal position, wider economy and society,

3.117. Preventing crises will also have knock on implications for the Government fiscal position. As was evident from the 2007-08 financial crisis, the UK Government experienced the largest budget deficit in its peacetime history to date. The aftermath of the crisis led the Government to introduce a series of measures to support the economy, including a temporary reduction in value added taxes (VAT) and a Government cash outlay of 9.8% of GDP at the time[32]. The crisis also led to large scale job losses, resulting in a greater proportion of the population qualifying for social welfare. This reduced income meant the exchequer collected less tax as a greater share of the population fell into a lower income tax bracket. Therefore, requiring banks to hold appropriate levels of capital should in theory, prevent such strain on the fiscal position in future.

[32] Office for Budget Responsibility Fiscal Risks Report (2017): https://cdn.obr.uk/July_2017_Fiscal_risks.pdf

Supporting EU market access for UK firms

3.118. The UK and EU have substantially aligned regulatory standards that supports access for UK firms to EU markets Implementing the remaining Basel standards in CRRII supports the ongoing UK / EU relationship and equivalence decisions. These decisions support UK competitiveness and prevent wider economic costs.

Strong and resilient global financial system

3.119. Inconsistent application of prudential standards across jurisdictions can lead to regulatory arbitrage, whereby banks seeks to operate in those jurisdictions where the regulatory burden is lowest. This can incentivise a “race to the bottom”, where national authorities appeal to businesses to set up operations in their jurisdiction by lowering prudential standards. This can have the impact of lowering confidence in the resilience of the financial system, affecting business sentiment and investor confidence. More importantly, it could mean that a financial crisis in one jurisdiction would then be more likely to spill over into other jurisdictions.

3.120. This can be avoided with consistent application of prudential standards, providing additional benefits to the global economy.

Economic costs

Long-term cost of capital

3.121. Equity capital can be costly to finance, particularly where firms need to raise significant quantities to meet near-term regulatory changes, as opposed to retaining greater share of retained earnings over time. The consequences could be higher costs for borrowers (higher interest rates and / or fees), or lower availability of credit. This could have knock on impacts to the level of consumption and investment, which impacts the steady-state level of national economic output.

3.122. The LEI study finds that a 1 percentage point increase in the capital ratio requirement translates to a median 0.09% decline in the level of output. Brooke et al judge that a 1 percentage point increase in capital requirements could lead to an increase in lending spreads between 5 and 10 basis points. Assuming a full pass-through of funding costs to lending spreads, they estimate permanent annual losses in output between 0.01% and 0.05%.

Short-term transition costs

3.123. These include the cost of implementing the standards themselves, which are borne by firms in terms of compliance officers familiarising themselves with the new standards, developing new or adapting current IT systems, as well as adapting to changing reporting requirements, which will have implications for resources.

3.124. With regards to the UK regime, the Government has assumed that the length and complexity of the regime is comparable to the length and complexity of CRRII plus the equivalent of Basel 3.1 measures in ‘Finalising Post-Crisis Reforms’. In the absence of any legislation on Basel 3.1 measures, it has therefore been assumed that the length of the legislation compliance officers are required to read is 2 times the length of CRRII.

3.125. The mean hourly wages of in-house compliance staff are expected to be £22 per hour, while those of external consultants are expected to be £24 per hour33. These wage costs are inflated by 20.6% to reflect non-wage labour costs. While it is not known how many in-house staff will be used by credit institutions versus external consultants, an average wage cost of £23 per hour has been assumed. The PRA is responsible for the prudential regulation and supervision of around 1,500 banks, building societies, credit unions, insurers and major investment firms in the UK.

3.126. Reading speed declines with text complexity. An assessment of the complexity of CRRII yields a Flesch-Kinkaid readability score that suggests a reading speed of 80 words per minute. IFR/IFD legislation is 125,392 words long. This suggests a reading time of 26 hours. Multiplied by 2 – to capture CRRII and Basel 3.1 - and this totals 52 hours. The familiarisation costs to financial institutions will therefore be £1.794m in 2021-22.

Determining the impact on the UK

3.127. Brooke et al (2015) suggest that the optimum range for Tier 1 capital requirements is around 10-14%, which in typical risk environments should yield net benefits in the UK.

3.128. Evidence from on-going analysis by the PRA – which is based on data firms have shared with the PRA – indicates that the day-1 RWA impact (i.e. not including the output floor) is likely to be low, and somewhere between 0 and 5% increase in total UK banking RWAs.

3.129. Capital impacts would be consequentially less. The exact impact would depend on how firms choose to implement the standards, what business and regulatory optimisations they make to their balance sheets, and some final calibration changes BCBS is undertaking. The impact of the output floor (which will be fully implemented by 2028) is highly uncertain and further work is required to understand its impact.

3.130. Based on the PRA's current analysis, there is nothing to suggest capital requirements will not remain within (or close to) the optimal range proposed by Brooke et al (2015).

3.131. The PRA's estimate is based on data provided by UK firms. Previous studies published by the BCBS and the EBA, grouped the UK impact within the cohort of EU banks. This is not representative of the impact expected in the UK. There are several factors that distinguishes the potential impact in UK relative to that estimated across the Europe, including:

a. average IRB risk weights are lower amongst EU banks than UK banks, and therefore the effect of the output floor is estimated to be greater in the EU than the UK;

b. EBA analysis has assumed conservative implementation options in areas where the UK already sets capital requirements under Pillar 2 (e.g. supervisors in the UK already require firms to increase minimum capital requirements to

[33] Office for National Statistics (2018) Annual Survey of Hours and Earnings, Table 4.5a – gross hourly pay by SIC07

capture historical operational losses) or for activities that are not a significant portion of the UK banking sector's business; and

c. the UK has already introduced a leverage ratio requirement for large firms, and this would continue to be binding for some firms irrespective of changes in the measure of risk-weighted assets under Basel 3.1.

3.132. In terms of how the short-term transition costs may affect the balance of costs and benefits, an analysis of these costs has been undertaken by the EBA.[34] The EBA cite that such transitional costs are modest and fade away over time.

3.133. The analysis supporting this conclusion and further analysis setting out the impact of the Basel reforms on the UK, will be published by the PRA as part of their consultation process.

3.134. The counterfactuals of the BCBS Monitoring Report does not account for wider policy programmes in train, that may impact the overall capital shortfall and change in capital ratios. These include the European Banking Authorities Internal Rating Based Model Repair programme[35] and the Prudential Regulatory Authority's proposed changes to the risk-weighted capital requirements in relation to residential mortgage portfolios. In particular, the IRB repair programme should lead to improvements in modelling practices and bring about the desired consistency the Basel standards aim to achieve. The PRA's proposed changes would have notable impacts on the measurement of credit risk.

Small and MicroBusiness Assessment (SaMBA)

3.135. The aim of this primary legislation is to ensure that the UK has the full set of powers necessary to introduce updated prudential rules for banks in the UK. The primary legislation itself will not directly affect UK firms. The final impact will depend on the implementation of prudential rules through secondary legislation and PRA rules.

3.136. In its current form, the CRR applies to all banks, building societies, credit institutions and PRA designated firms. A full list of these firms is published by the PRA[36]. The majority of these firms classify as "large" as they employ more than 49 people.

3.137. There are good reasons to apply prudential regulation across all firms, as insufficient levels of capital in one firm can still have implications for the domestic banking system. Prudential regulation aligns risk-taking incentives with broader implications for the wider economy.

[34] European Banking Authority (December 2019), Basel III reforms: Impact study and key recommendations: https://eba.europa.eu/sites/default/documents/files/document_library//Basel%20III%20reforms%20-%20Impact%20study%20and%20key%20recommendations%20%20macroeconomic%20assessment%20credit%20valuation%20adjustment%20and%20market%20risk.pdf

[35] EBA publishes report on progress made on its roadmap to repair IRB models, European Banking Authority, 2019 https://eba.europa.eu/eba-publishes-report-on-progress-made-on-its-roadmap-to-repair-irb-models

[36] Which Firms Does the PRA Regulate, Bank of England. https://www.bankofengland.co.uk/prudential-regulation/authorisations/which-firms-does-the-pra-regulate

3.138. It is important to note that compliance with the Basel standards focuses on implementation of the standards across larger institutions that are systemically important and those that have been identified as G-SIBs.

3.139. In implementing Basel, the UK intends to adopt a proportionate approach that does not disproportionately impact smaller firms that hold less complex portfolios of assets. In supporting this, the Government has previously set the PRA a secondary objective to support domestic competition. The PRA has itself taken steps to understand the barriers, which arise in prudential regulation and the steps they intend to take to ensure that prudential regulation in the UK is applied proportionately across banks while maintaining the resilience of the financial system.[37]

Wider Impacts.

3.140. There are no wider impacts associated with this measure

Summary

3.141. Prudential regulation ensures firms have enough capital and liquidity to operate effectively through periods of economic stress without causing harm to their customers, markets, and the wider financial system.

3.142. Due to the interconnected nature of banking and systemic investment activities, international standards on prudential regulation are crucial.

3.143. The Government the PRA and the FCA are committed to a prudential regulation regime that supports financial stability, economic growth, and competition amongst firms. After the transition period, the Government will prioritise the implementation of global standards to maintain the UK's position as a world-leading financial services centre.

3.144. The UK played an active role in negotiating and agreeing the Third Basel Accord (Basel III, as finalised by Basel 3.1) at the international level and is committed to its full, timely, and consistent implementation alongside other major jurisdictions. Through the Financial Services Bill, HM Treasury intends to take powers to enable the implementation of the remaining Basel III standards that will not have been incorporated into UK legislation by the end of the EU exit transition period.

3.145. The measures will also include measures contained in CRRII that support EU market access.

Description of Implementation Plan

3.146. It is expected that regulations and rules that would otherwise have been introduced in the EU's Capital Requirements Regulations and Capital Requirements Directive will be implemented shortly after Royal Assent of the Financial Services Bill.

[37] Credit union meets Robot, Sam Woods, Bank of England, 2019: https://www.bankofengland.co.uk/-/media/boe/files/speech/2019/credit-union-meets-robot-speech-by-sam-woods.pdf

3.147. For Basel 3.1 measures, rules and regulations will be in place no later than 1 January 2023 to ensure the UK meets its international obligations to implement remaining Basel standards.

LIBOR Transition

Problem Under Consideration

Background to LIBOR

4.1 Interest rate benchmarks are regularly calculated indices that reflect interest rates for bank lending and borrowing and are published or publicly accessible (often by paying a subscription). They underpin a wide array of financial instruments used in global financial markets. The use of interest rate benchmarks to price financial contracts reduces their complexity and facilitates standardisation. This lowers transaction costs and enhances liquidity, especially if particular reference rates are widely used. As a result, certain reference rates are now deeply embedded in financial systems, especially in credit products and interest rate derivative contracts.

4.2 LIBOR, which was first published as a formalised rate on 1 January 1986, is the most widely used and well-established benchmark in the world. In particular LIBOR is the most referenced benchmark in USD, GBP, CHF and JPY (where TIBOR is also a major rate). LIBOR is also calculated in EURO but EURIBOR is much more commonly used. LIBOR, EURIBOR and TIBOR are often referred to as "IBORs".

4.3 LIBOR is referenced in outstanding contracts worth trillions of dollars[38] in maturities ranging from overnight to more than 30 years. LIBOR reference rates are used in a variety of different credit-based products governed by very different arrangements. This includes mortgages, loans (consumer and commercial), structured products, money market instruments, and fixed income products; however, by far the largest exposure is in the derivatives market.

Calculation of LIBOR

4.4 LIBOR is now produced by Ice Benchmark Administration Limited ("IBA") and based on the combination of one of the following:

i. five currencies: GBP (Sterling), USD (Dollar), EUR (Euro), CHF (Swiss Franc) and JPY (Yen); and
ii. seven tenors: overnight, one week, one month, two months, three months, six months and one year.

4.5 IBA calculates LIBOR based on submissions that are made to IBA each day by a number of major global banks (the "panel banks")[39]. They use a waterfall methodology[40] which requires submissions to be based on actual transactions (to the extent that this is possible) and the expert judgement of the panel banks when insufficient eligible transactions are available.

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[38] Global Regulator Ratchets Up Pressure on Banks and Markets to Ditch LIBOR, Reuters. https://www.reuters.com/article/us-libor-markets-regulator/global-regulator-ratchets-up-pressure-on-banks-and-markets-to-ditch-libor-idUSKBN1YM1WJ
[39] Intercontinental Exchange, LIBOR Calculation. https://www.theice.com/iba/libor#calculation
[40] Intercontinental Commodities Exchange, LIBOR Methodology. https://www.theice.com/iba/libor#methodology

Manipulation of LIBOR

4.6 Beginning in 2012, an international investigation into LIBOR revealed widespread manipulation of IBORS dating back several years. Manipulation of LIBOR was possible because of the reliance of its methodology on expert judgement and the lack of proper governance and controls within bank treasury functions around making submissions. This was particularly evident during the 2008 global financial crisis, where market conditions saw activity in the interbank-lending market fall away.

Regulation of LIBOR

4.7 In response to global concerns about the integrity of benchmarks and their susceptibility to manipulation following the LIBOR scandal of 2012 (and other benchmark scandals), The International Organization of Securities Commissions (IOSCO) established a task force to develop principles to support the quality and resilience of benchmarks. This resulted in the publication of the Principles for Financial Benchmarks[41] in July 2013.

4.8 The European Union then introduced the Benchmarks Regulation ("the BMR") in June 2016, most of the provisions of which came into general effect in January 2018. The BMR's principal objectives are to restore investor and consumer confidence in the accuracy, robustness and integrity of indices used as benchmarks in the financial sector. The FCA has regulatory oversight of benchmark administrators in the UK.

4.9 The FCA has regulated LIBOR since 2013 (initially under a domestic regime and subsequently under the BMR). Since then significant improvements have been made to LIBOR through the introduction of regulation, the work of IBA, and the work of the twenty panel banks that submit contributions to the benchmark. In particular, the quality of the governance and controls around submission and administration of the rate has improved significantly.

4.10 Some use of LIBOR – notably its use in non-consumer loans, and in bonds issued by non-supervised entities – is not within scope of the BMR.

Transition away from LIBOR

4.11 In 2014, the Financial Stability Board (FSB) made clear that, due to risks to their integrity, continued use of major interest rate benchmarks represented a potentially serious source of systemic risk. They recommended that these rates should be anchored, to the greatest extent possible, in actual transactions. However, this has been difficult to achieve in respect of LIBOR as the underlying market that LIBOR seeks to measure – the market for unsecured wholesale term lending to banks – is no longer very active, particularly in some currency/tenor pairs. This means that LIBOR is now substantially sustained by the use of "expert judgement" by the panel banks to form many of their submissions.

4.12 In order to prevent an unplanned cessation of LIBOR and the global financial stability impact such a cessation would have had, Andrew Bailey (the CEO of the FCA until 16

[41] Principles for Financial Benchmarks, International Organization of Securities Commissions (2013): https://www.iosco.org/library/pubdocs/pdf/IOSCOPD415.pdf

March 2020) noted that the FCA has "spent a lot of time persuading panel banks to continue submitting to LIBOR" [42] and has given a public commitment regarding the life of LIBOR as a benchmark. In the same speech, he stated that as a result of the panel banks' voluntary agreement to continue submitting to LIBOR until December 2021, the FCA indicated that it would not be necessary for them to use their powers to compel the banks to continue to contribute LIBOR submissions to IBA after this date. The departure of some individual panel banks could mean that LIBOR no longer properly represents the wider market it claims to measure (i.e. it would become 'unrepresentative'): in such circumstances the BMR requires that publication must cease within a reasonable time period. In the worst case, the departure of panel banks could make production of LIBOR in the current manner impossible. That would leave counterparties to and holders of contracts in which payments are determined by reference to LIBOR rates without an agreed means of determining those payments.

4.13 In the absence of any compulsion by the FCA to continue contributing to LIBOR from end-2021, panel banks will be free to cease their contributions to LIBOR. This means the publication of LIBOR in its current form cannot be guaranteed beyond end-2021 and if the Government does not act there is a strong possibility that LIBOR will cease to exist.

4.14 Working groups have been set up in each LIBOR jurisdiction to identify alternative Risk-Free Rates (RFRs) onto which LIBOR referencing contracts may transition, and markets have begun transitioning away from LIBOR onto these RFRs. The alternative rates are:

- GBP (UK) – SONIA
- USD (US) – SOFR
- JPY (Japan)– TONA
- EUR (Europe) – €STR
- CHF (Switzerland) – SARON

4.15 These RFRs are not direct replacements for LIBOR – unlike LIBOR, they do not contain any credit spread element. Some contracts, particularly in cash markets, face barriers to transition onto RFRs and are at risk of frustration if LIBOR ceases (see below for more details). This presents a major financial stability and market conduct risk. A legislative safety net is therefore required for these 'tough legacy' contracts.

Rationale for Intervention

4.16 As mentioned before the global exposure to LIBOR is hugely significant. While the Government does not expect the majority of these to be trapped or frustrated in the event of LIBOR's cessation, due to the extensive use of LIBOR, even a small percentage would represent a significant sum.

4.17 Moreover, some contracts, particularly in cash markets (i.e. loans, securitisations, mortgages and commercial contracts), face barriers to moving off LIBOR at all. Additionally, there are some LIBOR-referencing 'non-financial contracts', such as leases or consumer loans, that face the same problems.

[42] Andrew Bailey Speech at Bloomberg London, 27 July 2017: https://www.fca.org.uk/news/speeches/the-future-of-libor

4.18 There are also significant challenges involved in renegotiating certain instruments: whilst some contracts are bilateral and renegotiation may be possible, many contracts are multilateral and involve obtaining the consent of multiple parties before a change to the contract can be affected. In some cases, achieving consensus on the changes is likely to be difficult or even impossible due to the number of parties involved, or due to the "threshold" of consent that must be achieved for the contract to be changed. Given the challenges to certain parties voluntarily moving onto RFRs before 2021, the FCA believe that there will be a significant number of contracts that will:

a) be "trapped" using LIBOR at the end of 2021, with no appropriate fallbacks[43] in their contracts if LIBOR ceases; or
b) have fallbacks that will be activated if LIBOR ends, but that will be inappropriate as they will be designed to cater for the short-term unavailability of LIBOR (rather than its permanent cessation), leaving the contract significantly affected by the end of LIBOR.

4.19 These contracts are known as "tough legacy" and they are at risk of frustration or termination if the rate ceases. In particular, cessation may result in widespread legal disputes between parties to contracts. For example, where a party is dissatisfied with the operation of an inappropriate fallback or where the failure to provide for cessation might result in contract frustration. This could sometimes result in loan acceleration in some situations and might also lead to instruments that are hedges becoming unhedged.

4.20 Clearly it is in the interests of financial markets and their customers that the pool of contracts referencing LIBOR is shrunk to an irreducible core ahead of end-2021 through active transition to RFRs, leaving behind only those contracts that genuinely have no or inappropriate alternatives and no realistic ability to be renegotiated. It is recognised by the FCA and the Government that without a legislative solution, these tough legacy contracts that genuinely cannot move onto alternative rates voluntarily will be at risk of frustration, as they will be reliant on a benchmark which has ceased to exist, or will be moved onto a fallback rate that is evidently not suitable for the remaining life of the contract. Therefore, the Government recognises that a legislative solution is required to deal with the issue of "tough legacy" contracts.

4.21 The remainder of this section provides more detail on the legacy issues for the major types of products which use LIBOR and sets out the extent to which they can be considered tough legacy.

Policy Objective

4.22 The policy objective is to seek to mitigate the potential financial stability risk which could result from 'tough legacy' contracts following the cessation of LIBOR post-2021.

[43] A "fallback" is a provision in the contract that would be activated in the event that LIBOR were to cease to become available – for instance, in the event that LIBOR ceases to be published, some contracts may specify an alternative benchmark which may be used, or stipulate a formula to be used for calculating interest (etc.). Fallbacks vary greatly from contract to contract.

4.23 Even though it is regulated by the FCA, LIBOR is used globally, with significant use of USD LIBOR internationally. Therefore, it is necessary to seek a consistent approach across different LIBOR currencies, coordinating with other jurisdictions.

4.24 The Government intends to provide the FCA with powers to manage the transition away from LIBOR and to ensure that it ceases in as orderly a manner as possible. At a high-level the FCA could use these 'enhanced powers' to:

- prohibit the use of a benchmark only (i.e. not all benchmarks provided by an administrator) when the benchmark is declared no longer representative due to panel bank withdrawal or in the event of a review of its representativeness by the FCA, and neither the administrator nor the FCA can or intends to restore its representativeness;
- allow 'legacy use' of the benchmark for some or all legacy contracts where it considers this to be appropriate;
- insist on a change to a benchmark's methodology where the benchmark is unrepresentative and its representativeness will not be restored, so that it is no longer reliant on panel bank submissions prior to it being unviable; and
- insist on agreement by the regulator that critical benchmark administrators' cessation plans meet regulatory requirements, to help to ensure orderly wind-down of the benchmark.

Description of Options Considered

4.25 **Option 0: Do nothing**. As above, the consequences of inaction would be a significant risk to global financial stability. Complete cessation of LIBOR is a high-risk scenario for 'tough legacy' contracts that will remain outstanding post end-2021. It would very likely result in legal disputes causing market disruption and financial instability.

4.26 The exact number of contracts that would likely be impacted by legal disputes is extremely difficult to estimate due to lack of visibility of individual contract terms such as any fallbacks they include that govern what happens if LIBOR ceases, and how the terms of the contract can be amended to add or revise any such provisions or to move to a RFR.

4.27 **Option 1: Direct Legislation**. An alternative option to amending the BMR would be to legislate to directly replace all occurrences of LIBOR with an alternative rate. However, this option has at least two major issues:

i. It would only apply to contracts written under the law of a UK jurisdiction and would, therefore, only solve the global problem for a subset of contracts. For this approach to be effective, each individual jurisdiction where LIBOR is used would need to legislate independently – there isn't evidence of this happening sufficiently globally at this stage to be assured of this approach.

ii. The Government's view is that it would not be possible to reach a consensus on what alternative rate or formula should replace LIBOR across all 35 of its currency/tenor pairs in the current timeframe. It is likely that, for some currencies at least, the optimal rate would be an adjustment of a forward-looking RFR term rate: such rates are at various

stages of development for some LIBOR currencies but none are yet available for use commercially.

4.28 **Option 2 (Preferred option):** Amending the BMR through the Financial Services Bill. The policy detail of this measure is outlined below.

Policy Outline

4.29 The Government will broadly seek to provide the FCA with the following powers:

4.30 **Methodology Change:** the existing provisions of the BMR give the FCA a limited power to require an administrator to change the methodology of a critical benchmark. This power is limited to circumstances in which the change would restore the benchmark's representativeness. to the Government intends to strengthen the FCA's powers in this area, to allow such a change even where it does not restore representativeness, where its restoration is not appropriate or feasible, if the change furthers the FCA's objectives of market integrity and consumer protection. This will ensure that the FCA can (when appropriate) impose a methodology that is not reliant on panel bank submissions. This is important in ensuring that LIBOR can continue to be produced if the departure of panel banks would risk making LIBOR unrepresentative and potentially volatile, or making LIBOR's current method of calculation unviable.

4.31 **Stop new use of LIBOR:** The Government intends to ensure that the FCA will be able to prevent parties from including references to LIBOR (in either its current or synthetic form) in new financial contracts and instruments at an appropriate point after 2021. Stopping new usage of LIBOR will be important, as the ultimate aim is to phase LIBOR out of existence completely. It is therefore critical that parties cease writing contracts or instruments so that the pool of contracts that reference LIBOR steadily diminishes from end-2021 onwards as those contracts expire over time. The FCA has existing powers under the BMR to prevent the use of a benchmark by suspending or withdrawing the authorisation of its administrator. However, the grounds for suspension or withdrawal are narrow and relate to misconduct by the administrator or its wish to renounce its authorisation. The existing powers are consequently unsuitable for situations in which the FCA needs to take action as a result of the circumstances of a particular benchmark, rather than because of the administrator's general conduct.

4.32 **Permit usage of synthetic LIBOR:** The Government aims to protect tough legacy contracts from the risk of frustration by allowing the use of synthetic LIBOR by certain parties in circumstances where the use of LIBOR has otherwise been prohibited.

4.33 **Cessation plans:** The Government wants to strengthen existing requirements for administrators' plans for the cessation of their benchmarks – at present these plans must be published but there are no requirements as to their content. The impending end of LIBOR has demonstrated that these requirements are inadequate. In addition, the Government wants the FCA to review critical benchmark administrators' cessation plans to ensure they meet the new requirements.

Policy Costs

4.34 There are no direct EANDCB impacts associated with this primary legislation. Any impacts will be dependent upon the FCA's use of powers.

4.35 The Better Regulation Framework contains a number of administrative exclusions. Measures that fall within one of the administrative exclusions are considered as regulatory provisions but do not score against the Business Impact Target (BIT), a measure of the economic impact on business of the qualifying regulatory provisions introduced by the government.

4.36 One of the administrative exclusions is for "systemic financial risk", which is defined in the Framework[44], which also states that the Impact Assessment for measures should identify the underlying evidence of systemic financial risk. The LIBOR transition measure falls within the scope of this administrative exclusion, and therefore the evidence of the systemic financial risk has been set out above.

Policy Benefits

4.37 The Government considers that the most appropriate way of achieving the policy goal (mitigating the financial stability risk of the potential cessation of LIBOR) will be to make amendments to the BMR, as amended by the Benchmarks (Amendment) (EU Exit) Regulations 2018 from the end of the Implementation Period (or 'BMR'), rather than to create new freestanding legislation. The BMR provides an existing framework for considering a benchmark's representativeness and potential wind-down.

4.38 The Government's view is that enhancing and adding to some of the FCA's existing powers under the BMR will give the FCA a clearer framework in which to manage a LIBOR cessation scenario.

4.39 This approach ensures that the FCA has the tools and flexibility to respond in a cessation scenario, as well as being able to deliver an approach that could benefit a wider range of LIBOR users, not just those with contracts written under UK law.

4.40 Furthermore, the changes described in this option would apply to other benchmarks that are designated as critical in the future. This means that the regulatory framework will be better able to deal with the potential wind-down of any future critical benchmarks, providing certainty to the market in such a situation and reducing the risk that further legislation would be required.

Small and MicroBusiness Assessment (SaMBA)

4.41 There are no direct EANDCB impacts associated with this primary legislation. Any impacts will be dependent upon the FCA's use of powers.

[44] See page 33 of the Better Regulation Framework guidance: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/872342/better-regulation-guidance.pdf

Wider Impacts

4.42 There are no wider impacts associated with this measure.

Summary

4.43 The publication of LIBOR in its current form cannot be guaranteed beyond end-2021. This measure sets out the Governments proposal for managing the potential financial stability risk which could result from the cessation of LIBOR. It proposes amending the existing legislation for the regulation of benchmarks (BMR) to give the FCA enhanced powers to:

- prohibit the use of a benchmark only;
- allow 'legacy use' of the benchmark where necessary;
- change a benchmark's methodology; and
- ensure that critical benchmark administrators' cessation plans meet certain requirements.

Extension of the transitional period for benchmarks with non-UK administrators

Problem Under Consideration

5.1 This measure extends the transitional provision for third country benchmarks under the UK Benchmarks Regulation (BMR) from 31 December 2022 to 31 December 2025.

5.2 Under the BMR which retained the directly applicable EU law for benchmarks, by end-2022 third country benchmarks will need to successfully apply for "endorsement" of a specific benchmark or for "recognition" as an administrator, or benefit from an "equivalence" determination made by HM Treasury for their benchmarks to be used in new contracts in the UK. After end-2022, the use of 'non-authorised' third country benchmarks may continue in legacy contracts that existed before the end of the BMR transitional period but mature after 2022. However, BMR supervised entities will not be allowed to enter into new contracts referencing unauthorised third country benchmarks.

5.3 The EU introduced the BMR in 2016 to restore investor and consumer confidence in the accuracy, robustness and integrity of indices used as benchmarks in the financial sector. The BMR places requirements on, amongst others, administrators, supervised users of and supervised contributors to benchmarks. These requirements relate to issues including methodology, governance and transparency. The EU BMR has directly applied in the UK since 1 January 2018. To ensure that the existing regime under the BMR continues to operate effectively following EU Exit, the Government made amendments to address deficiencies through the Benchmarks (Amendment and Transitional Provision) (EU Exit) Regulations 2019. The BMR will take effect at the end of the EU Exit Transition Period (TP).

5.4 On 25 February 2019, the EU announced its decision[45] to extend the BMR third country transitional period from end 2019 to end 2021 through Regulation (EU) 2019/2089 (known as the 'low carbon benchmarks' legislation) which amended the EU BMR and came into force on 10 December 2019. This extension was to provide additional time for third country benchmarks to be recognised as equivalent or endorsed for use in the EU. On 5 September 2019, the UK Government extended the transitional period in the BMR from end 2019 to end-2022 under the Financial Services (Electronic Money, Payment Services and Miscellaneous Amendments) (EU Exit) Regulations 2019. This was introduced to allow more time for third country benchmarks to be registered with the FCA under the BMR and to make consequent changes to the requirements relating to the UK Benchmark Register. These changes were intended to come into force at the end of the TP.

5.5 However, in response to the EU consultation on the BMR review published in October 2019, industry has voiced concerns that many third country benchmarks are likely to be unable or simply unwilling to come through the existing third country regimes and to be registered with relevant national competent authorities, including the FCA.

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[45] European Commission Press Release - Sustainable finance: Commission welcomes agreement on a new generation of low-carbon benchmarks https://ec.europa.eu/commission/presscorner/detail/en/IP_19_1418

5.6 The Government's view is that this additional period of time alone, even until December 2022 under the BMR, is unlikely to resolve these concerns and ensure that UK markets have access to these benchmarks. This is problematic, especially where there are few alternatives to replace third country benchmarks in the UK (e.g. FX spot rate benchmarks). Losing access to these benchmarks could have serious repercussions given their widespread use by UK firms for risk management, treasury financing and overseas investment.

5.7 Therefore, the Government is considering which changes would be appropriate to the existing third country regime to provide long-term legal certainty for UK users. This work is ongoing. In the interim, the Government considers it appropriate to further extend the BMR third country transitional period until end-2025 to allow the Government to consider and operationalise possible changes.

Rationale for Intervention

5.8 Following the extension of the third country transitional period in the BMR until 31 December 2022, there remains concern that, where third country administrators do intend to register with the FCA, they will be unable to do so using one of the access routes in the BMR:

- Equivalence: this is an assessment as to whether a third country has equivalent regulatory and supervisory outcomes to those set out in both EU and after the end of the TP, UK legislation.

- To date, the European Commission has adopted two equivalence decisions pertaining to seven financial benchmarks administered in Australia and Singapore. These are directly applicable in the UK and will continue to apply at the end of the Transition Period as a part of the UK's onshored equivalence framework.

- As the population of third country benchmarks used in the UK is significant and most non-EEA jurisdictions (i.e. jurisdictions outside of the European Economic Area (EEA)) do not have benchmark-specific regulatory rules, the UK will explore how to best support the use of global non-UK benchmarks which adhere to equivalent regulatory outcomes.

- Endorsement: this requires third country administrators finding a UK supervised entity to endorse their benchmarks. The endorsing entity is required to be responsible for the endorsed benchmarks on an ongoing basis. Industry stakeholders have expressed concerns about the lack of clarity around the legal framework for endorsement. There are currently only two third country administrators registered under the EU BMR through endorsement.

- Recognition: administrators who cannot find a UK supervised entity to endorse them will need to appoint a UK legal representative. Industry stakeholders have expressed concerns about the lack of clarity around the legal framework for recognition. There are currently six third country administrators who are included on the EU BMR register under recognition.

5.9 In addition, there is a risk that some third country administrators may not intend to seek recognition or endorsement as they lack economic incentives to do so. This is particularly the case given that some administrators do not receive a licence fee when their benchmarks are used. Some FX spot rate benchmarks are, for example, provided on a non-commercial basis.

Economic importance of third country benchmarks

5.10 UK corporates and financial services firms use third country benchmarks for a wide range of commercial purposes. These include gaining exposure to third country currencies and investments, risk management of currency or market movements, corporate treasury financing, repatriating funds and overseas investment. There is no publicly available data on how many third country benchmarks are used in the UK, as such usage has not been previously regulated. However, the International Swaps and Derivatives Association estimated that the exposure to third country benchmarks in the EU is likely to be "very significant"[46].

5.11 The impact of not being able to use third country benchmarks is therefore likely to be significant. For example, the UK is the single largest centre for spot FX and derivative transactions, accounting for 43% and 50% of global turnover respectively in April 2019[47]. Average daily turnover in the UK was $3,576 billion in foreign exchange and $3,670 billion in over-the-counter interest rate derivatives. Any restrictions on the ability to use the benchmarks underlying these transactions could harm the UK's central role in these markets. Losing access to third country benchmarks could also push derivative transactions using those benchmarks from regulated trading venues to bilateral trading which is outside the scope of the BMR. This would undermine market transparency and investor protections.

5.12 Furthermore, FX spot rate benchmarks are widely used by UK businesses and investors to calculate the payments due for non-deliverable forwards (NDFs) listed and traded on UK trading venues. NDFs are financial contracts that allow firms to hedge exposures to currencies and products denominated in those currencies. By way of example, the gross notional value of NDF FX contracts in Korean Won (KRW) and Indian Rupee (IDR) – two of the most widely used FX spot rate benchmarks – in London amounts to approx. £500,000bn during January 2018 and August 2019[48].

5.13 Some of these FX spot rate benchmarks are provided on a non-commercial basis because their underlying currency is not fully convertible. A currency is not fully convertible where local central banks or treasury departments have exercised fiscal or monetary policy controls on offshore trading on their currency. In these cases, FX spot rate benchmarks will be provided on a non-commercial basis and reflect a variety of

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[46] Briefing on the need to extend the transition period of the Benchmark Regulation in respect of critical and uncritical benchmarks, ISDA (2018). https://www.isda.org/a/1hAEE/Briefing-on-the-need-to-extend-the-EU-Benchmarks-Regulation-Transition-P.pdf

[47] BIS Triennial Survey of Foreign Exchange and Over-The-Counter Interest Rate Derivatives Markets in April 2019, Bank of England (2019). https://www.bankofengland.co.uk/-/media/boe/files/news/2019/september/bis-triennial-survey-of-foreign-exchange-and-over-the-counter-interest-rate-derivatives-markets.pdf?la=en&hash=E533B2F6D2A36EF027AB87C9C9E082EAC2C5BD84

[48] MiFID transaction reporting

policy choices. These FX spot rate benchmarks are particularly prevalent in relation to a number of Asian currencies. Due to the nature of these FX spot rate benchmarks, they would therefore currently not be eligible for equivalence, recognition or endorsement under the BMR. There would also seem to be no economic incentives for them to go through any of the three BMR routes in order to continue accessing UK markets. Further, there would be few, if any, alternatives in the UK market to these benchmarks.

5.14 This means that UK users will lose access to these important FX spot rate benchmarks once the third country transitional period expires at the end of 2022 under the BMR. This could have a significant negative impact on the UK economy and business operations. UK businesses may be unable to hedge risks against foreign currency fluctuations and price movements and ultimately, may stop investing in, and carrying out business with, the relevant countries and currencies.

5.15 Further, due to lack of previous regulation over third country benchmarks, it is not yet possible to fully understand the extent of their use by UK users. However the Government's view is that there is a wider set of third country benchmarks, possibly extending beyond the subset of FX spot rate benchmarks, that may be affected by the difficulty to comply with the BMR by end 2022.

EU BMR review

5.16 The European Commission published a consultation in October 2019[49] and an inception impact assessment in March 2020[50] to consider policy options to ensure continued access to non-EU benchmarks where there are few alternatives in the EU. The Commission is expected to publish a legislative proposal in 2020.

Policy Objective

5.17 The extension aims to provide immediate legal certainty for UK users and to provide the Government with the time necessary to consider and operationalise any possible changes to the BMR third country regime.

Description of Options Considered

5.18 **Option 0 – Do nothing.** Without action, it is likely that a number of widely used third country benchmarks will no longer be available in the UK after 31 December 2022. Losing access to these benchmarks could undermine the UK's position as the centre for global FX and derivatives markets. It would also have serious repercussions given their widespread use by UK firms for risk management, treasury financing and overseas investment.

[49] Public Consultation Document – Review of EU Benchmark Regulation, European Commission (2019):https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/2019-benchmark-review-consultation-document_en.pdf

[50] Financial Benchmarks – review of EU Rules, European Commission (2020) https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12268-Review-of-the-Benchmark-Regulation-

5.19 **Option 1 (preferred option):** extend the transitional provision for third country benchmarks under the UK Benchmarks Regulation (BMR) to 31 December 2025 using the Financial Services Bill.

Policy Outline

5.20 This measure will extend the third country transitional period from end-2022 to end-2025. During this time, third country benchmarks will not be required to register with the FCA. UK users will be able to continue using third country benchmarks in existing and new contracts. The Government will continue to consider a policy response to concerns raised with the future use of third country benchmarks the UK.

Policy Benefits

5.21 This measure will maintain the status quo for third country benchmarks under the BMR until 2025. There is no publicly available data to show the full extent of the usage of third country benchmarks in the UK although it is widely considered to be significant. By way of example, the gross notional value of NDF FX contracts in Korean Won (KRW) and Indian Rupee (IDR) – two of the most widely used FX spot rate benchmarks – in London amounts to approx. £500,000bn during January 2018 and August 2019[51].

Policy Costs

5.22 As this measure legislates for the continuation of the current regime, there will be no additional EANDCB costs to UK users of third country benchmarks.

Small and MicroBusiness Assessment (SaMBA)

5.23 As above, there are no costs to small or micro business associated with this measure.

Wider Impacts

5.24 There are no wider impacts associated with this measure.

Summary

5.25 This measure will extend the existing transitional provision under the BMR for third country benchmarks until end-2025. During this time, UK firms will be able to continue using important third country benchmarks, which are used to perform a wide range of corporate functions. This measure will therefore extend current regime, without creating additional costs for UK firms. The Government will continue to consider a policy response to concerns raised with the future use of third country benchmarks in the UK.

[51] MiFID transaction reporting

Promoting openness to overseas markets

Market access arrangements for financial services between the UK and Gibraltar

Problem Under Consideration

6.1 As a result of both the UK and Gibraltar leaving the European Union (EU), the legal framework that provides for mutual market access and aligned standards require amendment. EU law allows authorised financial services firms to access markets across EU member states. However, prior to the UK and Gibraltar's exit from the European Union, Gibraltar was treated to be part of the UK for the purposes of EU financial services law and therefore, the EU passporting rights that exist between EU member states did not apply between the UK and Gibraltar.

6.2 Instead, the rights of Gibraltar and UK headquartered firms to respectively access the UK and Gibraltar market on the basis of authorisation in their home jurisdiction was provided for separately in UK and Gibraltar law, based on the EEA passport model. Specifically, market access between the UK and Gibraltar for financial services firms was provided by the Financial Services and Markets Act 2000 (Gibraltar) Order 2001 ("the Gibraltar Order 2001") and similar legislation in Gibraltar. The passport for Gibraltar payment service providers, payment institutions, authorised e-money institutions and registered account information service providers was provided for separately in domestically implemented EU legislation in the UK.

6.3 Ahead of the introduction of the new permanent Gibraltar Authorisation Regime (GAR), the Government has already introduced the Financial Services (Gibraltar) (Amendment) (EU Exit) Regulations 2019 and the Gibraltar (Miscellaneous Amendments) (EU Exit) Regulations 2019 which protect Gibraltar firms accessing the UK market from suddenly losing their access rights as a result of EU Exit. These arrangements are however temporary and do not provide an effective long-term legislative regime for market access.

6.4 As market access is a sovereign matter, the Government will legislate for the access of Gibraltar-based firms into the UK market, and it will be the Government of Gibraltar's responsibility to legislate in domestic legislation for the reciprocal market access for persons with a Part 4A permission ("UK-based persons"). In order to facilitate the access of UK-based persons to the Gibraltarian market, the Government will make provision in the Bill for the procedure that UK-based persons should follow as a precondition for accessing the Gibraltar market. In particular, the Government will require UK-based persons to have a Part 4A permission (a domestic authorisation to carry on regulated activities in the UK) and to notify the UK regulators of their intention to operate in Gibraltar if such market access is available. The appropriate UK regulator would then notify the Gibraltar regulator. Ultimately, the Government of Gibraltar will decide the scope of inward market access by approving the specific regulated activities that a UK-based person will be able to carry on in Gibraltar. The precise impact on UK-based persons will depend on the market access offered by the Government of

Gibraltar, however, consideration is given to the potential costs involved in the relevant section.

Scope of the Impact Assessment

6.5 The impacts of the GAR on Gibraltar-based firms intending to operate in the UK are out of scope for the purposes of this assessment. As a result, this impact assessment considers the direct impacts on bodies and consumers in the UK as a result of the introduction of the GAR.

Rationale for Intervention

6.6 In recent years, Gibraltar financial services firms have benefitted from the existing market access arrangements between the UK and Gibraltar. According to 2019 data from the FCA, there are over 100 Gibraltar-based firms passporting into the UK, including insurance firms, credit institutions, asset managers and e-money firms. Gibraltar-based firms have offered UK consumers a greater choice of financial products from a wider range of providers, and now service a large retail customer base in the UK.

6.7 The Gibraltarian insurance sector is the most significant area of economic activity, as it underwrites around £5 billion in premiums every year, according to 2018 data from the Government of Gibraltar[52]. Approximately 92% of Gibraltar's insurance turnover is UK-facing and, more than 20% of motor insurance policies in the UK are underwritten by Gibraltar-based insurers[53] [54]. Data published by the Association of British Insurers (ABI) noted that, in 2018, 20 million households had motor insurance out of the 26.5 million households in the UK[55]

6.8 In recognition of the close and unique relationship between the two territories, the Government intends to introduce a bespoke framework that will offer wholesale and retail market access into the UK to Gibraltar-based financial services firms replacing passporting arrangements. This framework will be reflective of the unique historic relationship between Gibraltar and the UK and the starting point of shared EU legislation which enabled passporting. Without the introduction of a new framework, individuals and business could face a more limited choice of financial services products on the market.

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[52] 2018 Government of Gibraltar data from all Gibraltar-based insurers. Available at: https://www.thinkgibraltar.gi/insurance

[53] Speech by Huw Evans at Gibraltar Finance Insurance Breakfast, 7 November 2019. Available at: https://www.abi.org.uk/news/speeches/2019/huw-evans-speech-at-gibraltar-finance-insurance-breakfast-7-november-2019/

[54] Speech by Minister Isola of Gibraltar at Gibraltar Finance Insurance Breakfast, 7 November 2019. As reported in: https://www.insurancebusinessmag.com/uk/news/breaking-news/life-after-brexit-for-the-uk-and-gibraltar-insurance-industries-191237.aspx

[55] Association of British Insurers (2019). Available at: https://www.abi.org.uk/globalassets/files/publications/public/key-facts/key_facts_2019_spread.pdf

Policy Objective

6.9 The objective of the Government's new framework, the Gibraltar Authorisation Regime ("GAR"), is to provide market access for financial services between the UK and Gibraltar if they intend to carry on GAR-approved activities, promote the safety and soundness of firms in the UK and Gibraltar, protect consumers and financial stability, and ensure that consumers continue to benefit from a choice of financial products. The new framework will also respect Gibraltar's regulatory autonomy and reflect the close and unique relationship between the two jurisdictions.

6.10 In order to deliver on those objectives, the GAR will be based on aligned, high standards of financial regulation, supervision, authorisation and enforcement, and underpinned by bespoke arrangements for information-sharing, transparency and cooperation between the UK and Gibraltar regulators. Under the GAR, the Government will enhance the scope of powers available to UK regulators in relation to the Gibraltar firms accessing the UK market, building on changes introduced in the onshored regime. The Gibraltarian regulator will continue to be the primary regulator of GAR firms, however, the UK regulators will be granted enhanced powers in a limited number of circumstances in cases where the GFSC might not have been able to address a specific threat to the UK market, consumers or financial stability.

Description of Options Considered

6.11 **Option 0: Do nothing –** If the Government failed to legislate for a new long-term regime, Gibraltar would lose its current breadth and depth of access to the UK market once the temporary onshored arrangements cease.

6.12 At that point the Government of Gibraltar would have the option of pursuing third country equivalence in the areas of financial services where HM Treasury plans to introduce equivalence provisions for other jurisdictions.

6.13 Should Gibraltar express an interest in securing an equivalence determination, the UK regulators would have to undertake an assessment of the jurisdiction's regulatory regime for the relevant activities. In this regard, it would not be possible to anticipate the areas where the Government of Gibraltar would express an interest in equivalence or the business decisions of Gibraltar-based firms.

6.14 If Gibraltar were to lose its current arrangements and rely on equivalence regimes, there could be significant disruption to UK consumers. This would particularly affect that 20% of motor insurance policy holders that are serviced by Gibraltar-based insurers, given that there are no equivalence provisions enabling market access for retail insurers into the UK.

6.15 In this scenario, the Government would have to consider legislating for transitional arrangements enabling Gibraltar-based firms to exit the UK market in an orderly manner, through a process similar to the Temporary Permissions Regime (TPR) and Supervised Run-Off regime (SRO) which will be available to EEA firms for a limited period of time after the passporting regime ends.

6.16 On balance, applying an equivalence framework to Gibraltar would fail to recognise the special relationship that binds the UK and Gibraltar, and would result in a more limited choice of financial services products for UK consumers.

6.17 **Option 1: Continuation of the current arrangements –** The Government could decide to extend the temporary arrangements in place indefinitely. The Financial Services (Gibraltar) (Amendment) (EU Exit) Regulations 2019 and the Gibraltar (Miscellaneous Amendments) (EU Exit) Regulations 2019 already protect the market access of Gibraltar-based firms in the UK.

6.18 However, those arrangements, dependent on retained EU legislation, were never intended to be permanent. These arrangements do not include any obligation for close cooperation between the UK regulators and the Gibraltarian regulators to ensure that an aligned set of standards and outcomes is maintained.

6.19 Membership of the EU entailed an institutional framework for enforcing common prudential standards, coordinated supervision and enhanced consumer and investor protection through national and EU supervisory authorities, such as competent authorities of Member States, the EBA, the European Securities and Markets Authority (ESMA), and the European Insurance and Occupational Pensions Authority. Having left the EU together, new structures will be required to promote consistent and effective regulation of firms operating between the UK and Gibraltar.

6.20 If the current arrangements were extended, there would be no overarching regulatory framework to ensure that standards remained adequately aligned, potentially exposing UK consumers of Gibraltarian products to additional economic risks. The lack of a framework to deliver aligned prudential standards would increase the risk of Gibraltar-based firms becoming insolvent, adding pressure to the need for financial compensation from Financial Services Compensation Scheme ("the FSCS"). This is considered further in the policy costings section.

6.21 **Option 2: (Preferred option) Legislate for a bespoke market access regime through the Financial Services Bill.** The GAR will allow Gibraltar-based financial services firms to access the UK market as "authorised persons" under FSMA, without having to apply for authorisation from the UK regulators if they intend to carry on GAR-approved activities in the UK.

6.22 The GAR will differ from the equivalence regimes intended for more distant relationships, and it will reflect the unique historic position of Gibraltar and the shared starting point of passporting for the UK and Gibraltar. The GAR will be based on aligned, high standards of financial regulation and enforcement, and underpinned by modern arrangements for information-sharing, transparency and co-operation between the UK and Gibraltar regulators. This closer institutional co-operation will be fundamental in enabling a deeper scope of market access for Gibraltar-based firms.

6.23 The GAR is expected to lower the number and severity of future firm failures as a result of the strong alignment of regulatory law and practice, as well as the new arrangements enabling UK regulators to have timely access to information and the powers to make

effective interventions. The main elements of the GAR are outlined in the section below.

Policy Outline

6.24 The GAR will allow Gibraltar-based financial services firms to access the UK market as "authorised persons" under FSMA, without having to apply for authorisation from the UK regulators if they intend to carry on GAR-approved activities in the UK. The GAR will be established by a mix of: primary legislation (including dedicated powers for secondary legislation and guidance), secondary legislation, regulators' rules, MOUs and policy statements and guidance.

6.25 HM Treasury will specify by statutory instrument the UK regulated activities for which market access is granted, and the corresponding activities that a firm wishing to conduct these activities in the UK must already be authorised to carry on in Gibraltar by the Gibraltar Financial Services Commission ("the GFSC"). It is expected that the specified activities will be a subset of the regulated activities under the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (RAO) (SI 2001/544), reflecting the composition of Gibraltar-based firms currently conducting business in the UK.

6.26 Under the GAR, Gibraltar firms entering the UK market for the first time will undergo a process of notification to obtain GAR authorisation. Firms will notify the GFSC of their intention to carry on specific approved activities in the UK, and in turn the GFSC will provide its consent for the firm to do so and notify the appropriate UK regulator(s).

6.27 Access of Gibraltar-based firms to the UK market will be conditional on Gibraltar aligning its relevant law and practice with that of the UK, on that access complying with certain objectives, such as financial stability and consumer protection, as well as on Gibraltarian and UK governments and regulators closely cooperating as part of this regime. The principle of alignment underpinning the GAR will ensure that regulatory and supervisory standards are applied in a consistent manner by UK and Gibraltarian institutions. Relevant law and practice includes, for example, any future changes to the UK's financial regulation, law and supervisory practice and any related areas of relevance, such as data protection law and insolvency law as well as the basis of supervision and enforcement in Gibraltar and the way in which it is undertaken by Gibraltar authorities. However, Gibraltar firms in the GAR will continue to remain subject to the laws and rules of Gibraltar and will be supervised by the GFSC, and may be subject to further UK requirements as is the case now.

6.28 Under the cooperation condition, HM Treasury, the Government of Gibraltar and all the appropriate regulators in the two jurisdictions will work together to coordinate their regulatory, supervisory and, if need be, insolvency activity to support the delivery of a well-functioning GAR regime. In addition, HM Treasury will operate a regular review process to ensure that the conditions of alignment of Gibraltarian law and practice with UK legislation, cooperation, and objectives continue to be fulfilled in time. If one of these conditions were not to be maintained, HM Treasury would engage with the

Government of Gibraltar to resolve any issues bilaterally and would have the ability to, ultimately, withdraw approval for a specified regulated activity or activities.

6.29 The FSCS is the UK's statutory financial compensation scheme for customers of authorised financial services firms The Government believes that UK customers of Gibraltar-based firms should benefit from an adequate degree of protection under the GAR through the FSCS or the comparable Gibraltarian scheme where this is deemed necessary for the purposes of UK's financial stability and/or consumer protection. The Financial Services Bill will include a power for HM Treasury to set out in regulations the types of firms which are not eligible to participate in the FSCS. The Government will also enable individuals and eligible small businesses availing of financial services sold in the UK from Gibraltar-based firms to refer disputes to the UK Financial Ombudsman Service (FOS). The FCA will be responsible for providing for this change in its rules once the GAR comes into effect.

Policy Benefits

6.30 2018 data from the Government of Gibraltar indicated that more than 20% of motor insurance policies in the UK being written by Gibraltar-based insurers[56]. The GAR is expected to deliver benefits to the UK consumer by continuing to enable individuals and small businesses to purchase financial services products from a wider range of providers, regardless of whether they are based in the UK or in Gibraltar. The Government expects consumers of all backgrounds to benefit from this ample range of products.

6.31 The GAR is also expected to reduce financial risks to consumers which could emerge from Gibraltar-based firms accessing the UK market if Gibraltar's law and practice were not to be aligned with the UK's. In the past, significant areas of financial services regulation have been set at the EU level and the Government of Gibraltar and the GFSC fulfilled the function of transposing EU directives into Gibraltar legislation in these areas of financial services. However, in some areas the UK has introduced more robust standards than those required at the EU level. Under the GAR, which allows for deeper and broader market access, the Government would expect Gibraltar firms operating in the UK to do so on the basis of Gibraltar being aligned with the UK standards as they are and as they develop over time.

6.32 The GAR will enable the continuation of financial services trade between the UK and Gibraltar. Some Gibraltar-based firms play a key role in driving competition and innovation in the UK market by offering specialist financial services products.

6.33 While the direct impacts on Gibraltar-based businesses are out of scope of this exercise, it should also be noted that the financial services sector plays an important role in Gibraltar's economic model, with up to 20% of their national GDP deriving from

[56] 2018 Government of Gibraltar data from all Gibraltar-based insurers. Available at: https://www.thinkgibraltar.gi/insurance

financial services according to 2016 data from the American Chamber of Commerce in Gibraltar.[57]

Policy Costs

6.34 This legislation will enable Gibraltar-based financial services firms to operate in the UK if they intend to carry on GAR-approved activities. Those Gibraltar-based firms - both branches and services firms - are considered non-UK entities. Having considered paragraph 1.2.1 of the Better Regulation Framework and paragraph 2.11 of the Green Book guidance, and having consulted the Regulatory Policy Committee Secretariat and Better Regulation Executive for further guidance, the Government considers these non-UK entities to be out of scope for the purposes of this impact assessment and the EANDCB analysis.

6.35 However, it is expected that there will be an operational cost to the FCA and PRA in supporting the delivery of the GAR framework, as there is a cost at present of administering the passporting arrangements for EEA firms. The number of Gibraltar-based firms accessing the UK market is low in comparison to the overall number of firms in the UK (58,000), with over a 100 Gibraltar-based firms in operation in the UK according to FCA data from 2019.There will also be an on-going cost to the administration of the GAR, for example, from maintaining the FCA's public register of financial services firms, and the close cooperation with Gibraltarian authorities to ensure that the regulatory and supervisory standards of Gibraltar-based firms are in line with those of the UK.

6.36 The FCA and the PRA are independent bodies from Government and raise funding for their operations through an annual levy set through their annual consultation. The regulatory costs for UK and Gibraltar-based firms will continue to be recovered using the existing fee structure. Though, the outcome of future fee annual consultations cannot be pre-judged. The administration of the GAR framework will be considered part of HM Treasury's regular function as the body responsible for the UK's financial services policy.

6.37 . Under the present arrangements, some Gibraltar-based firms participate in the UK's FSCS. It is expected that under the GAR certain types of Gibraltar-based firms will continue to participate in the UK's FSCS in the sub-schemes where this is deemed necessary for the purposes of the UK's financial stability and/or consumer protection, particularly in areas of high economic activity such as the insurance sector.

6.38 In 2018/2019, the FSCS paid £144m in compensation for claims against 22 estates in the general insurance category[58]. That is an average cost of £6.5m per failure. According to data shared by the PRA, between 2001 and 2020, there have been eight

[57] Data available at: https://www.amcham.gi/8-about-gibraltar

[58] Financial Services Compensation Scheme, Class Statement 2019/19. Available at: https://www.fscs.org.uk/globalassets/annual-reports-and-class-statements/fscs-class-statement-2018-19-final-web.pdf

cases of Gibraltar-based insurers failing with consequences to the FSCS of up to £120m, approximately. If the current onshored arrangements were extended indefinitely, and there was no institutional framework to deliver alignment of law and practice and supervision based on close cooperation, the Government estimates that this pattern could be expected to continue or deteriorate due to non-alignment, creating a similar or higher cost to the FSCS.

6.39 Under the GAR, the access of Gibraltar-based firms to the UK market will depend on Gibraltar aligning its relevant law and practice with that of the UK, on that access complying with certain objectives, such as financial stability and consumer protection, as well as on Gibraltarian and UK governments and regulators closely cooperating so, the Government expects that the cost of a failure from a Gibraltarian insurer will be brought in line with those of non-Gibraltarian insurers and that Gibraltarian insurers should fail less often under the new regime.

6.40 Similarly, due to the alignment of standards and the deeper level of cooperation between the regulators that will underpin the regime, the Government does not expect UK firms to be at a competitive disadvantage in respect of Gibraltar-based firms operating in the UK market due to regulatory arbitrage.

6.41 The FSCS scheme is funded through a levy, which is consulted on every year. It would be difficult to estimate further at the present time the precise operational impacts of the GAR on the UK regulators and the UK's FSCS. As HM Treasury will designate through a statutory instrument the regulated activities for which market access is granted and some of those are expected to benefit from FSCS cover, a revised Impact Assessment will be produced on specific operational costs when access is granted reflecting the activities that come under the GAR.

6.42 In respect of UK firms, any impact or potential costs will depend on the market access arrangements legislated for by the Government of Gibraltar and are thus out of scope of this Impact Assessment. In addition to this, the domestic legislation brought forward by the Government will require UK-based persons to have a Part 4A permission (a domestic authorisation to carry on regulated activities in the UK) and to notify the UK regulators of their intention to operate in Gibraltar if such market access is available. As UK-based persons will therefore already have a Part 4A permission and must comply with the relevant regulatory requirements in domestic legislation, the Government expects that the impact of these provisions on UK-based persons will be negligible.

Small and MicroBusiness Assessment (SaMBA)

6.43 This measure does not have a direct impact on small and microbusiness based in the UK.

6.44 UK-based small and microbusinesses will be able to benefit, as customers, from the wide range of financial services products offering by Gibraltar-based firms in the UK.

Wider Impacts

6.45 There are no wider impacts associated with this measure.

Summary

6.46 This Impact Assessment has considered the need for government intervention to preserve the market access of Gibraltar-based financial services firms into the UK, as a result of both leaving the EU. In recent years, Gibraltar's financial services sector has benefitted from the arrangements in place and now service a significant customer base in the UK. Therefore, without the Government intervening to introduce a new framework, the existing temporary arrangements would remain in place without an institutional framework to enforce common standards, and arrangements may need to be put in place to enable firms to exit the UK market in an orderly fashion.

6.47 The Government will bring forward the GAR as part of Financial Services Bill, a bespoke framework that will offer wholesale and retail market access into the UK to Gibraltar-based financial services firms if they intend to carry on GAR-approved activities in the UK, replacing passporting arrangements. As market access is a sovereign matter, the UK Government will legislate for the access of Gibraltar-based firms into the UK market, and it will be the Government of Gibraltar's responsibility to legislate in domestic legislation for the reciprocal market access for UK firms.

6.48 The GAR framework will be reflective of the unique historic relationship between Gibraltar and the UK and the shared starting point of EU passporting. The GAR will be based on aligned, high standards of financial regulation, supervision, authorisation and enforcement, and underpinned by bespoke arrangements for information-sharing, transparency and co-operation between the UK and Gibraltar regulators.

6.49 The GAR is expected to deliver benefits to the UK consumer by continuing to enable individuals and small businesses to purchase financial services products from a wider range of providers and by reducing the risk of Gibraltar-based firms accessing the UK market without being aligned with UK standards. Under the GAR, the Government will continue to offer UK customers of Gibraltar-based firms a degree of protection under certain FSCS sub-schemes, or Gibraltarian comparable schemes.

6.50 Given that Gibraltar-based financial services firms are non-UK entities, this impact assessment treats Gibraltar-based firms as out of scope for the purposes of this analysis. Other potential costs of UK public bodies or UK firms have been considered and a revised Impact Assessment will be produced when HM Treasury publishes the list of designated activities to be granted access. No additional impacts on small and microbusinesses have been identified.

6.51 As market access is a sovereign matter, it will be the Government of Gibraltar's responsibility to legislate in domestic legislation for the reciprocal market access for UK firms. In addition, the Government will bring forward domestic legislation to facilitate the access of UK-based persons to Gibraltar by requiring them to hold a Part 4A permission and notify the UK regulators of their intentions before they can operate in

Gibraltar. The impact on UK-based persons will depend on the market access arrangements legislated for by the Government of Gibraltar. The impact of the notification is expected to be negligible, as UK-based persons already have a Part 4A domestic authorisation and comply with the appropriate regulatory requirements from the UK regulators.

Description of Implementation Plan

6.52 The GAR framework will be implemented through the Financial Services Bill and will require further secondary legislation to be commenced. The framework will replace the temporary arrangements enabling market access for Gibraltar.

6.53 Ahead of the commencement of the GAR framework the UK regulators will update or modify their existing Memoranda of Understanding (MoUs) with the GFSC to support this new relationship.

Overseas Funds Regime

Problem Under Consideration

7.1 The proposed 'Overseas Funds Regime' (OFR) addresses two issues relating to the marketing of overseas investment funds into the UK:

i. the process by which an overseas fund can gain 'recognised' status to market to UK retail investors; and

ii. the restriction on the marketing of overseas money market funds (MMFs).

Existing regimes for overseas funds

7.2 Investment funds that are authorised under the Undertakings for Collective Investment In Transferable Securities Directive are known as UCITS and benefit from passporting rights[59] to market to retail investors across the European Economic Area (EEA). There are around 9,000 EEA UCITS which are passporting in the UK.[60] These funds form an integral part of the UK's investment market for retail and institutional investors (which often need to invest in retail funds due to the nature of their investment mandate).

7.3 Investment funds domiciled in countries outside of the EU can only be sold to retail investors in the UK by applying under a process set out in Section 272 of FSMA (s.272), to gain 'recognised' status. This requires a detailed and resource intensive assessment by the FCA of each individual fund. The FCA is required to examine whether the fund gives adequate protection to investors in the scheme, and also that its arrangements for constitution and management, the powers and duties of its operator, and its trustee and depositary are also adequate.

7.4 The UK is currently in a Transition Period, following its departure from the EU on 31 January 2020. At the end of this Transition Period, the passporting system will cease. Recognising the important role that EEA domiciled investment funds play in the UK market, the Government has introduced a 'temporary marketing permissions regime' (TMPR). This will enable EEA UCITS to continue marketing into the UK for a temporary period,[61] provided they had exercised their right to market in the UK before the end of the transition period. Currently, legislation specifies that funds wishing to market to retail investors in the UK after the end of the TMPR must be recognised under s.272 of FSMA.

Restrictions on overseas money market funds

7.5 MMFs are a type of fund invested in liquid assets, such as cash, government and corporate debt. They provide an important cash management function for financial institutions, corporations and governments.

[59] Passporting refers to the right of a firm authorised in an EEEA country to market its funds within any other EEA country. This follows the principle of the free movement of capital in the EU single market.
[60] 'Authorised and funds', FCA, 2020 (https://www.fca.org.uk/firms/authorised-recognised-funds)
[61] This is currently set at 3 years, with the ability for HM Treasury to extend the temporary period.

7.6 At the end of the transition period, passporting will cease and MMFs which currently passport into the UK will be permitted to enter the TMPR. After exiting the TMPR, this existing 'stock' of MMFs will be able to access the UK market through the relevant third country regime, either by notifying under the 'national private placement regime', which would allow them to be sold to professional investors (such as pension funds or large corporates), or becoming recognised under s.272, which would allow them to become recognised for sale to retail investors.

7.7 However, UK legislation currently restricts any new overseas MMFs, whether they intend to market to retail or to professional investors, from accessing the UK market.[62]

Rationale for Intervention

7.8 According to FCA analysis, as of June 2020, there is a 'stock' of around 9,000 funds which have notified their intention to enter the TMPR. These funds form an important part of the UK's investment market and the vast majority would wish to continue to secure long term access to the UK market.

7.9 The fund-by-fund nature of the assessment means s.272 is poorly suited to processing this large volume of applications, as it would not be practical for the FCA, nor would it present an appropriate or efficient use of the regulator's resources. The Government therefore committed, in 2018, to review the existing regime set out in s.272.

'Flow' of new overseas funds

7.10 There were also questions over whether s.272, which was designed for individual funds, is a proportionate and viable solution for recognising the 'flow' of new overseas funds in the long-term. Due to the time and costs involved in going through a s.272 assessment, very few funds have done so; there are currently only around 30 funds which are recognised under s.272.

7.11 Creating a more proportionate regime for overseas funds, and addressing the restriction on MMFs, would ensure that UK investors continue to have access to a broad range of investment products. This is particularly the case for certain types of funds which there are very few of in the UK, such as MMFs and exchange traded funds (ETFs, passive funds that track an index and are listed on a stock exchange).

Policy Objectives

7.12 The proposed OFR intends to reduce the operational burden on firms and the FCA when EEA retail funds currently marketing in the UK seek to gain permanent recognition following the end of the Transition Period. Going forward it will also establish a more appropriate and efficient basis for recognising overseas retail funds from countries outside of the EU.

7.13 The Government is also seeking to promote the interconnectedness of financial markets and consumer choice, advance trading opportunities around the world, and –

[62] This is a result of amendments to be introduced by the Money Market Funds (Amendment) (EU Exit) Regulations 2019 to reflect the UK's new position outside the EU.

in providing an effective mechanism for funds domiciled overseas to market into the UK – the OFR may support bilateral agreements with other countries in future.

7.14 Finally, the OFR aims to ensure vibrant competition in the UK investment market, which will promote choice, driving innovation and value for investors.

Description of Options Considered

7.15 **Option 0: Do Nothing.** If the Government undertook no steps to improve the route by which overseas funds gain recognition in the UK, at the end of the TMPR all funds wishing to continue marketing in the UK would be required to undergo a s.272 assessment. This will require each fund operator to undergo a resource intensive process in order to submit a detailed application form to the FCA. Assessing and processing these applications would be a considerable operational burden for the FCA.

7.16 **Option 1 - Simplify Section 272.** The Government has considered whether undertaking further steps to simplify the process of s.272, such as removing some requirements alone may reduce the burden on fund operators and the FCA. The Government consulted on three ways in which the process of s.272 could be simplified.

7.17 When assessing an application for individual recognition from an overseas fund, the FCA currently must have regard to any rule of law and any matters which are or could be the subject of rules. The Government proposes to amend this requirement so that the FCA only needs to consider matters which are currently subject to rules, rather than having to anticipate the potential application of rules which do not yet exist, when determining a fund's recognition. As the obligation to consider rules which are not yet in existence is open-ended and difficult to assess, this amendment would focus the scope of the FCA's assessment to what is ascertainable at the time of the fund's application, clarifying the FCA's obligation and therefore saving time.

7.18 Once a fund has been recognised, legislation requires that the operator of the fund must submit written notice to the FCA when there is any proposed change to the fund's operation or management for FCA approval, even where the changes are immaterial and would be of little or no relevance to the FCA. The Government proposes to amend this requirement to give the FCA greater flexibility to decide which changes it needs to approve.

7.19 There is also a requirement that the fund operator must provide written notice to the FCA a month prior to any replacement of the operator, trustee or depositary. However, this requirement may be impractical in certain situations, e.g. it may be incompatible with other countries' regulations, or where an operator suddenly enters insolvency proceedings. The Government proposes to amend this requirement so that funds should provide their notification as soon as reasonably practicable, but still be given within the month before the change is made.

7.20 None of these amendments to s.272 would change the fundamental nature of the fund-by-fund assessment process or significantly speed up the FCA's examination of whether the fund gives adequate protection or significantly speed up the FCA's

examination of whether the fund gives adequate protection to investors. It is not possible to go further in simplifying s.272 given the confines of what the FCA is obliged to examine (as set out paragraph 7.3) while ensuring confidence that the schemes are suitable to be recognised in the UK as being suitable for sale to retail investors. Therefore, the costs of pursuing this option are likely to be similar to the "do nothing" option.

7.21 **Option 2 (Preferred option) – Introduce equivalence regimes for retail funds and money market funds (i.e. the Overseas Fund Regime) through the Financial Services Bill.** The Government's preferred approach is to introduce two equivalence regimes which will enable HM Treasury to make an 'equivalence determination' in respect of another country's regulatory regime for retail funds or MMFs:

i. Following an equivalence determination for retail funds, funds from that country will be able to go through a simplified application process to market to retail investors in the UK.

ii. Following an equivalence determination for MMFs, MMFs from that country will be able to gain market access into the UK.

Policy Outline

Equivalence regimes for retail funds and MMFs

7.22 The OFR will encompass two separate equivalence regimes for overseas funds: one for overseas retail funds and one for MMFs.

7.23 Before making an equivalence determination, HM Treasury will, in the normal course of business, request a report from the FCA on the regulatory regime of the overseas country. This report will inform HM Treasury which, in order to make an equivalence determination, must be satisfied that the regulatory and supervisory regime of the other country meets the required standard on an outcomes basis.

7.24 Under both equivalence regimes, HM Treasury must also be satisfied that there are, or there will be, adequate supervisory cooperation arrangements in place between the FCA and the national competent authority (NCA).

Additional requirements for retail funds

7.25 The OFR will also allow HM Treasury to stipulate additional requirements under the equivalence regime for retail funds, with which incoming funds must comply as a condition of being recognised in the UK.

7.26 Additional requirements may not be necessary in all cases and would be based on aspects of the UK framework which were judged to be important for reasons including to ensure consistency or comparability between overseas funds and those domiciled in the UK. Additional requirements would be set out in the secondary legislation which gives effect to the equivalence determination.

Process for individual funds marketing into the UK

7.27 Once an equivalence determination is made, the process for individual funds wishing to market in the UK will depend on the type of fund and the type of investors to whom they intend to market.

7.28 Retail funds (including MMFs marketed to retail investors) which fall within an equivalence determination, will need to make an application to the FCA to gain recognition. This process is intended to be simple and straightforward. The FCA will not be responsible for verifying funds' compliance with the overseas regulatory framework, reflecting the fact that the equivalence determination has already confirmed that the funds offer equivalent investor protection. The FCA will however need to be satisfied that funds comply with any additional requirements and will be able to gather additional information from funds as necessary. This has the ability to radically reduce the operational burden on FCA of registering funds seeking to exit the TMPR and any additional funds wishing to access the UK market, using the process under s.272.

7.29 MMFs which fall within an equivalence determination and wish to market solely to professional clients will be required to submit a notification under the national private placement regime, which is the existing process for funds targeting professional investors.

Amendments to simplify s.272

7.30 The Government proposes to combine the OFR with Option 2 under this impact assessment, which will make s.272 more effective for the FCA and funds that fall outside an equivalence determination

Policy Costs and Benefits

Methodology

Scope of the impact assessment

7.31 This section explains which activities are included/excluded from the scope of the impact assessment, based on whether the activities are conducted in the UK or not. Having considered paragraph 1.2.1 of the Better Regulation Framework and paragraph 2.11 of the Green Book guidance, and having consulted the Regulatory Policy Committee Secretariat and Better Regulation Executive for further guidance, HM Treasury considers these non-UK entities to be out of scope for the purposes of this impact assessment and the EANDCB analysis.

7.32 Asset managers, which operate investment funds, often split their activities across different countries. While the portfolio management of overseas funds is often run from their operations in the UK regardless of where the fund is domiciled, the day-to-day operation of the fund is typically based in the same country in which the fund is domiciled (i.e. outside the UK for the purpose of the OFR).

7.33 The administrative costs and benefits of the OFR will principally affect the fund operator. Since the fund operators are domiciled overseas, the costs and benefits on fund

operators will fall outside the UK and are considered 'out of scope' of the impact assessment, in that it does not affect the EANDCB figure.. However, given any costs and benefits on fund operators will likely be passed onto investors, for instance through product costs and fees (although fund operators may partially absorb the costs in their profits), it will be considered where it is relevant.

7.34 The main quantifiable impact that will materialise in the UK are the costs and benefits to the FCA, which the impact assessment will focus on. However, it is worth noting that under all options, the cost to the FCA of registering funds will be borne by the funds themselves in the form of application fees or ongoing periodic fees. Fund operators are likely to pass these costs to investors. The calculations performed in this impact assessment therefore provide an indication of the potential scale of impact on funds themselves, which ultimately would be borne by investors.

7.35 As the impact assessment anticipates that any cost to the FCA will be borne by fund operators themselves, the net impact on the FCA under all options is zero. There is no impact on EANDCB, as the FCA is a public body, impacts on which would not normally be scored against the BIT[63].

7.36 The impact assessment also qualitatively considers the impacts on investors in the UK. These may either be retail investors (e.g. individuals saving for their retirement), or institutional investors (e.g. pension funds, local authorities, insurance companies, sovereign wealth funds, although some institutional investors are treated as 'retail clients' for regulatory purposes).

Baseline

7.37 For the purpose of this impact assessment, use of s.272 without changes (the 'do nothing' approach) is taken as the baseline that the OFR will be compared against. This is because s.272 is currently the only regime which would allow overseas funds (either from the EU or outside the EU) to market into the UK at the end of the transition period. The impact assessment will first calculate the cost of s.272, and then compare it with the cost of the OFR.

7.38 It is important to bear in mind that the OFR is being compared to estimated costs in a theoretical situation where overseas funds are processed under s.272. Currently, the majority of overseas funds are EEA UCITS and are marketing into the UK through passporting notifications, which bear a much smaller cost on the FCA and fund operators. However, as passporting will cease at the end of the transition period, the OFR is not being compared to the passporting regime.

Costs and benefits of the s.272 approach (baseline)

7.39 This section quantifies the administrative costs of the s.272 approach to the FCA, which will then be taken as the baseline for calculating the costs and benefits of the OFR. It will also consider any benefits and any non-monetised costs of s.272.

[63] *RPC short guidance note on issues around defining a business,* Regulatory Policy Committee

7.40 The administrative costs to the FCA of processing applications under s.272 can be split into the following:

i. One off costs: As s.272 and the FCA's IT systems to process the application are already in place, there will be no one-off costs for this.

ii. Processing 'stock' of existing EEA UCITS: The main cost to the FCA in the short term will be from staff costs associated with assessing and processing s.272 applications from the stock of EEA UCITS seeking to exit the TMPR.

iii. Processing 'flow' of new funds: There will also be ongoing costs relating to the flow of new funds which apply under s.272 to market within the UK.

Number of funds (s.272)

7.41 According to the FCA, around 9,000 funds have notified their intention to enter the TMPR. This indicates the number of funds that could potentially access the UK.

7.42 However, the s.272 application process is time consuming and costly for funds when compared to a straightforward passporting notification. The Government expects this to have an impact on the number of funds that apply, both initially and on an ongoing basis. As an indicator, the Government's consultation on this policy revealed an example of an EEA fund which had incurred costs of over £100,000 when lodging an application under s.272, in a process that took 8-9 months. In comparison, a passporting notification typically takes around 2-3 weeks and costs around £1,000-3,000 per fund.

7.43 Because passporting notifications are relatively inexpensive for funds, the Government understands that some funds have sought passporting permissions even where they do not actively market in the UK, or where UK investors are a small percentage of their overall business model. Faced with considerable up-front administrative costs, the Government expects that some funds would choose not to apply under s.272, for example legacy funds which are no longer marketed within the UK or those where market share was too small to make the activity economically viable.

7.44 As a result, the Government estimates that 10% to 30% of the existing stock of funds, which have notified their intention of entering the TMPR, would choose not to apply under s.272, suggesting that 6,300 to 8,100 funds in total would apply.

7.45 The FCA currently accepts around 720 notifications for new funds each year under the passporting regime. The Government also expects the flow of new funds applying each year to slow, with firms seeing the s.272 process as a considerable barrier to entry to the UK market. FCA estimates this could reduce the flow of new applications by 50% to 75%, suggesting annual rate of funds applying to under this option could range from to 180 to 360 each year.

Hours per application (s.272 approach)

7.46 The FCA estimates that processing s.272 applications takes around 245 hours per fund. FCA resources would be focused on evaluating the information provided,

challenging the applicant where they have concerns and ultimately making decisions based on their judgment on whether standard set in legislation has been met.

7.47 Only around 30 funds have ever been recognised under s.272, and the Government anticipates that processing much larger volumes of funds would allow FCA to find efficiencies in their processes – for example as they became more familiar with the types of applications and the applicable regulatory systems in the funds' home jurisdiction. It is difficult to predict how much time could be saved, but the Government estimates this could reduce the time spent on applications by between 40% and 60%.

7.48 To illustrate the magnitude of the cost on the FCA of s.272, taking the mid-point of the assumptions on number of funds and hours taken per application would suggest the FCA would need around 900,000 hours to process the applications by the end of the TMPR.

7.49 Assuming employees would be working 230 days per year, per employee and staff worked 7 hours a day on this task, not counting time needed for meetings and training, it would require around 600 full-time authorisation employees to complete this task within the 3 years of the TMPR. This is compared to the FCA's current authorisation team has the equivalent of 12 full time employees.

Hourly staff wage (s.272 approach)

7.50 Authorising this increased number of funds under s.272 would be an additional pressure on existing FCA staff, who would need to continue with their day to day activities. For the purposes of this Impact Assessment, it has been assumed that this temporary project would at least be partly staffed by contractors, and both FCA staff and contractors are assumed to have a salary equivalent to 'Business, research and administrative professionals' as defined by the Office for National Statistics,[64] which have median earnings of £23.57 per hour.[65] These wage costs are inflated by 21.95% to reflect non-wage labour costs, such as training of staff. This number is estimated using EUROSTAT data on non-wage costs.[66] Therefore, it has been estimated that an FCA employee processing these applications will cost £28.74 per hour.

Wage per hour (£) = 24 x 121.95% = £28.74

[64] 'Business, research and administrative professionals n.e.c' (Standard Occupational Classification, 2429) described by ONS as "Workers in this unit group advise on the formulation and implementation of policy in the public and private sectors, develop and implement substantial business, statistical and administrative systems, and perform a variety of functions not elsewhere classified [in group for Business, research and administrative professionals]."

[65] Annual Survey of Hours and Earnings (Table 14.5a, by occupation), ONS, 2019

[66] https://appsso.eurostat.ec.europa.eu/nui/submitViewTableAction.do - Non-wage costs in the UK make up 18% of total labour costs, as of 2019. From this it is possible to calculate that wage costs make up 82% of total labour costs. Therefore this gives inflation of 21.95% by dividing the percentage of non-wage labour costs by the percentage of wage labour costs (0.18/0.82 = 0.2195).

Total costs to FCA of processing applications (under s.272 approach)

7.51 The total cost to the FCA of processing s.272 applications has been estimated by multiplying the expected number of funds with the hours needed for each application and the hourly rate for employing staff to consider each application:

Cost to FCA of processing s.272 applications = number of funds x hours per application x hourly staff wage

7.52 Using the estimated ranges above, the low, high and best estimates for processing the stock of EEA UCITS and the flow of new funds under s.272 are as follows:

Table 7.1: Cost of processing s.272 applications

	Low	*High*	*Best estimate*
Processing stock of existing EEA UCITS (one-off cost)	£18,000,000	£34,000,000	£26,000,000
Processing flow of new funds (annual cost)	£510,000	£1,500,000	£1,000,000

**Figures rounded to 2 s.f.*

7.53 The best estimates in Table 7.1 above are used for calculating the estimated cost over a 10-year horizon. Taking the assumption that the FCA will be spreading the cost of processing the stock of existing EEA UCITS evenly over the three years of the TMPR (as originally legislated for), and the flow of new funds will be consistent each year, the administrative cost of s.272 for the FCA over a 10-year period is estimated as follows:

Table 7.2: Cost of processing s.272 applications over 10 years (£)

Year	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
Processing stock of EEA UCITS (£)	8.7m	8.7m	8.7m	0	0	0	0	0	0	0
Processing flow of new funds (£)	1m	1m	1m	1m	1m	1m	1m	1m	1m	1m
Total (£)	9.7m	9.7m	9.7m	1m	1m	1m	1m	1m	1m	1m

**Figures rounded to 2 s.f.*

Costs of processing further information from funds (s.272)

7.54 In addition to the cost of processing applications, there is an ongoing administrative cost to the FCA of receiving information from recognised funds. It is estimated that the FCA requires 3.5 full time employees to administer the current passporting notifications. The process under s.272 is much greater, because the current legislation requires that the operator of the fund must submit written notice to the FCA for its approval when there is any proposed change to the fund's operation or management, even where the changes are so immaterial that they would be of little or no relevance to the FCA or investors. There is also a requirement that the fund operator must provide written notice to the FCA a month prior to any replacement of the operator, trustee or depositary.

7.55 These written notices will require the FCA to assess, make administrative updates, and information about the replacement of an operator, trustee of depositary would require a review of whether it would be acceptable, and whether the fund could still be recognised. An approximate estimate is that the FCA would require at most an additional 10 full time employees, on an ongoing basis each year, to undertake this work. In practice, the number of employees required could vary depending on the number of funds which are recognised under s.272.

7.56 Again, it is estimated that FCA staff have salary equivalent to 'Business, research and administrative professionals' as defined by the Office for National Statistics, which have median annual salaries of £41,084.67 These wage costs are inflated to reflect non-wage labour costs, such as training of staff.

Annual salary (£) = 41,084 x 121.95% = £50,101.94 Total cost of additional employees (£) = 50,101.94 x 10 = £500,000 (2 s.f.)

Non-monetised costs of s.272 to fund operators (out of scope)

7.57 One of the main costs of s.272 for fund operators is the preparation of the application. This is because the responsibility is on fund operators to demonstrate that the fund meets the requirements in s.272 (as set out in paragraph 7.3). This includes, amongst other things, providing a legal comparison of the fund against the nearest comparable fund authorised in the UK and an explanation of why the fund provides adequate protection to investors, requiring significant legal resource.[68] As indicated in paragraph 7.37, an example of a s.272 application incurred costs of over £100,000.

7.58 In addition to the preparation of the application, fund operators will have to give application fees and periodic fees. The previous calculations give an indication of the costs which would need to be recovered through fees, as the FCA has no other sources of income. Application fees under s.272 vary depending on the type of fund, ranging from £1,500-£2,400 for EEA Alternative Investment Funds (any fund which is not a UCITS), and £8,000 for non-EEA funds.69 Periodic fees depend on the number of funds operated, starting at £1,425 for 1-2 funds (only for non-EEA funds as there are currently no periodic fees for EEA funds). In comparison, operators of EEA UCITS

[67] Annual Survey of Hours and Earnings (Table 14.7a, by occupation), ONS, 2019
[68] Apply for fund recognition, FCA, 2020, https://www.fca.org.uk/firms/authorised-recognised-funds/apply-fund-recognition
[69] *Fees manual*, FCA, June 2020

marketing through passporting currently have to pay £600 when notifying the FCA of their intention to market in the UK, and pay no periodic fees. While EEA UCITS would likely be on the lower end of the fee range of s.272, such fees may rise given the substantial increase in costs faced by the FCA.

7.59 Operators may also face increased costs of complying with further requirements as a condition of marketing in the UK. For example, the MRF with Hong Kong sets out further requirements on incoming funds, beyond what is required under Hong Kong regulation, including details of UK (FCA) rules which the funds must comply with.[70]

7.60 Although the impacts on fund operators do not impact on EANDCB (as they arise outside the UK), costs incurred are expected to be passed onto investors in the UK, including institutional investors. However, it is difficult to quantify the impact on investors as it depends on various factors, including the number of funds invested in, the extent to which costs are passed on rather than absorbed in profits, etc.

Non-monetised costs of s.272 to investors

7.61 In addition to increased costs to investors in the form of higher product costs and fees, there is likely to be a reduced choice of investment products. Due to the significant costs and time involved in making s.272 applications, some asset managers might withdraw products that could not be profitable under this option. This would result in a reduced fund range in the UK, potentially impacting on competition. Where products are discontinued it could trigger tax liabilities for investors and/or crystallise market losses.

7.62 This option would also not allow for any new MMFs to be marketed into the UK, beyond those which entered into the TMPR. There would be a competitive distortion because of the complete barrier to entry for new MMFs that could harm competition.

Benefits of the s.272 approach

7.63 There are no monetised benefits of relying on s.272. There is a non-monetised benefit of temporary job creation, as FCA would need to recruit people and to process the large volume anticipated of applications under s.272. However, while these jobs would benefit those who receive employment, it is assumed the employees would be skilled workers who could find other employment.

Costs and benefits of the OFR

7.64 In order to quantify the costs and benefits of introducing the OFR, this section will first calculate the administration cost of the OFR to the FCA, then compare it to the administration cost of s.272 (which was calculated in the section above).

7.65 The main benefit when compared to s.272 is considerable streamlining of FCA's process, which result in much lower administrative costs.

[70] *Circular: Mutual Recognition of Funds between UK and Hong Kong*, FCA

Costs of FCA assessment under OFR

7.66 Under the OFR, the FCA will ordinarily be required to produce a comprehensive report on the regulatory and supervisory regime of the overseas country, in relation to an entire category of funds (as opposed to individual funds).

7.67 The FCA has recently reached a mutual recognition of funds (MRF) agreement with Hong Kong. The FCA's assessment of the Hong Kong regime which enabled this agreement is similar to the type of assessment which would be the basis of its report for HM Treasury under the OFR.

7.68 There several factors worth noting when considering the FCA assessment of the Hong Kong regulatory regime as a proxy for the cost of assessments under OFR. First, although the assessment took two years in total, the allocation of resource was not consistent for the whole duration. Secondly, the Hong Kong regulator uses English as its official language, whereas some countries covered by the OFR will not. Thirdly, it was the first such assessment undertaken by the FCA, and the organisation may become quicker as it gains experience.

7.69 The FCA has instead suggested that per country or territory, their assessments could take a range of 6 to 12 months, by 3 to 4 full time employees on an estimated salary of £60,000. These employees are also expected to have a comprehensive understanding of both the law and practice of asset management in the UK and the relevant jurisdiction in question. This has resulted in a higher estimated salary, similar to that of a low-range Technical Specialist,71, than the administration level employees used earlier in Option 1 of the impact assessment. This is inflated by 21.95% to take into account non-wage costs, resulting in total wage costs of £73,170.

7.70 In order to calculate the cost to the FCA of assessing a country, the number of employees needed is multiplied by their salary and years in employment for conducting the assessment.

Costs = number of employees x total wage costs x years employment

7.71 Taking the numbers above, the low, high and best estimate for assessing a country is as follows:

Table 7.3: Cost of FCA assessment

	Low estimate	*High estimate*	*Best Estimate*
Assessment costs	£110,000	£290,000	£200,000

**Figures rounded to 2 s.f.*

7.72 In order to consider the cost to the FCA of making assessments over a 10-year horizon, a maximalist approach has been taken by assuming an assessment will need to be done for each EU Member State. Given the very high degree of harmonisation in rules across the EU, it is expected that there would be a reduction in costs in assessing the EU. Nonetheless, the FCA must assess whether the EU's rules have been transposed in each member state in a way which provides for equivalent regulatory outcomes. Therefore, a 50% reduction in costs per additional Member State has been estimated.

[71] FCA grading structure, FCA, https://www.fca.org.uk/publication/corporate/salary-ranges.pdf

The first assessment of an EU Member State would still cost the same, as the harmonising EU rules (e.g. the UCITS Directive and MMF Regulation) are yet to be assessed.

Cost of assessing the EU = Cost of conducting an assessment for 1 country + (Cost of conducting an assessment for 26 countries x 50%)

7.73 Taking the best estimate above, the total cost of assessing the EU is therefore estimated to be around £2,800,000.

7.74 For countries outside the EU, taking into account the time it takes to conduct an assessment and make an equivalence determination, and comparing with the time it took the FCA to agree the MRF with Hong Kong, for the purposes of this impact assessment, the Government has estimated a maximum of 5 equivalence assessments over a 10-year period. It is possible for the FCA to be asked to assess a number of countries before bilateral agreements are concluded, so the number of requests for FCA assessments might well be broader than the number of countries which eventually receive an equivalence determination.

7.75 Therefore, over a 10-year horizon, the costs to the FCA of making assessments are estimated as follows. If an equivalence determination is to be made for the EU, it is assumed that this will be done early in the TMPR, to allow FCA to process applications from funds under the OFR before the end of the TMPR. This cost is therefore spread evenly across the first two years. The costs for assessing non-EU countries are spread evenly in the remaining 8 years, although in reality, the costs would fluctuate depending on the volume of requests from HM Treasury for FCA reports.

Table 7.4: Cost of FCA assessments over 10 years (£)

Year	1	2	3	4	5	6	7	8	9	10
Assessment of EU countries	1.4m	1.4m	-	-	-	-	-	-	-	-
Assessment of non-EU countries	-	-	130,000	130,000	130,000	130,000	130,000	130,000	130,000	130,000

**Figures rounded to 2 s.f.*

Costs to FCA of processing OFR applications

7.76 The process for recognising individual retail funds under the OFR will be streamlined. The FCA will not be responsible for verifying funds' compliance with the overseas regulatory framework, reflecting the fact that the equivalence determination has already confirmed that funds in the specified category offer equivalent investor protection.

7.77 The FCA is expected to rely on self-certifications from funds that they are eligible for recognition, although it may request supplementary evidence it considers necessary, such as authorisation certificates. The FCA will also need to be satisfied that funds comply with any additional requirements, where they have been specified as part of an equivalence determination, which will have an impact on the time taken to process fund registrations.

7.78 Again, the administrative costs to the FCA of processing applications under the OFR can be split into the following:

i. *One off costs:* The FCA will need to set up new application forms and IT systems to process the applications under the OFR. It is not yet clear what the costs would be to set up such systems, as the details of the application process are yet to be decided by the FCA.

ii. *Processing 'stock' of existing EEA UCITS:* If an equivalence determination is made in relation to the EU or EU member states, the main cost to the FCA in the short-term will be processing OFR applications from the stock of EEA UCITS seeking to exit the TMPR.

iii. *Processing 'flow' of new funds:* There will be ongoing costs relating to the flow new funds which apply under the OFR to market within the UK.

Number of funds (OFR)

7.79 Stakeholders suggested during the consultation on this measure that they would be keen to continue to have access to the UK wherever possible. This impact assessment therefore assumes that from the 'stock' of existing UCITS, all 9,000 funds which have notified under the TMPR will apply under the OFR, where this is possible.

7.80 Since the process for applying under the OFR has been designed such that it is similar, in terms of the overall burden on fund operators, as passporting, no changes are expected to the rate of new funds marketing into the UK. It has been assumed that the 'flow' of new funds will remain steady at an average of 720 per year.

Hours per application and hourly staff wage (OFR)

7.81 The FCA has estimated that the time taken for a fund to be recognised under the OFR will range from 4 to 15 hours, and the average wage of a relevant FCA employee is estimated to be £28.74, including an uplift for non-wage costs (the same as the estimate used in paragraph 7.45).

Total costs to FCA of processing applications (OFR)

7.82 Similarly, the cost to the FCA of processing OFR applications has been estimated by multiplying the expected number of funds with the hours needed for each application and the hourly rate for employing staff to consider each application:

Cost to FCA of processing OFR applications = number of funds x hours per application x hourly staff wage

7.83 Using the numbers given above, the estimated costs of processing the stock of existing EEA UCITS and the flow of new funds are as follows:

Table 7.5: Cost of FCA processing OFR applications

	Low (4 hours)	*High (15 hours)*	*Best estimate*
Processing stock of existing EEA UCITS (one-off cost)	£1,000,000	£3,900,000	£2,500,000
Processing flow of new funds (annual cost)	£83,000	£310,000	£200,000

**Figures rounded to 2 s.f.*

7.84 This illustrates the considerable streamlining when compared to s.272, and provides an indication of the possible application fees, which are likely to be set at a level which would not dissuade existing passporting funds from applying.

7.85 To calculate the cost over a 10-year horizon the best estimates above are used and it is assumed that:

i. the EU is found equivalent, after 2 years, for the purposes of OFR

ii. the FCA spreads the cost of processing the stock of existing EEA UCITS evenly over remaining 3 years of the TMPR

iii. the flow of new funds is consistent each year after equivalence determinations are made (and is the same as the current run-rate of new passporting funds).

7.86 The administrative cost of OFR for the FCA over a 10-year period is estimated as follows:

Table 7.6: Cost of processing OFR applications over 10 years (£)

Year	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
Processing stock of EEA UCITS (£)	-	-	820,00	820,00	820,00	0	0	0	0	0
Processing flow of new funds (£)	-	-	200,00	200,00	200,00	200,00	200,00	200,00	200,00	200,00
Total (£)	-	-	1m	1m	1m	200,00	200,00	200,00	200,00	200,00

**Figures rounded to 2 s.f.*

Costs of processing further information from funds (OFR)

7.87 Under the OFR, the FCA will not be responsible for authorising or supervising overseas funds directly, as these responsibilities will fall to the fund's NCA. The OFR will however provide the FCA with the power to require funds to provide information, including regular confirmation that they are still eligible for recognition. When the FCA receives the regular confirmations, it will need to review them and make administrative updates to their records. However, information that the FCA receives from overseas funds will be less than under section 272.

7.88 An approximate estimate is that the FCA would require at most an additional 5 full time employees, on an ongoing basis each year, to undertake this work. These costs would only arise once funds are recognised under the OFR (so wouldn't arise before equivalence determinations are made). In practice, the number of employees would vary depending on number of funds recognised under the OFR, and the number and the nature of any additional requirements. The annual salaries and wage costs of staff are the same as in paragraph 7.50.

Total cost of additional employees (£) = 50,101.94 x 5 = £250,000 (2 s.f.)

Total costs and benefits of OFR when compared against s.272

7.89 The total costs of proceeding with the OFR when compared against the s.272 process, which is the baseline "do nothing" option, are set out in the table below over a 10-year period:

7.90 As shown throughout the impact assessment and in the indicative costs in Table 7.7, the OFR overall represents a substantial saving for the FCA, particularly in the earlier years when the stock of existing EEA funds would have been processed under s.272.

Table 7.7: Costs and benefits of OFR compared to s.272 (£)

Year	1	2	3	4	5	6	7	8	9	10
s272: Processing applications from stock of EEA UCITS	8,661,888	8,661,888	8,661,888	0	0	0	0	0	0	0
s272: Processing applications from flow	1,014,075	1,014,075	1,014,075	1,014,075	1,014,075	1,014,075	1,014,075	1,014,075	1,014,075	1,014,075
s272: Costs of processing further information	501,019	501,019	501,019	501,019	501,019	501,019	501,019	501,019	501,019	501,019
Total cost of s272	**10,176,982**	**10,176,982**	**10,176,982**	**1,515,094**	**1,515,094**	**1,515,094**	**1,515,094**	**1,515,094**	**1,515,094**	**1,515,094**
OFR: Assessment of EU countries	1,408,523	1,408,523	0	0	0	0	0	0	0	0
OFR: Assessment of non-EU countries	0	0	125,761	125,761	125,761	125,761	125,761	125,761	125,761	125,761
OFR: Processing applications from stock of EEA UCITS	0	0	819,193	819,193	819,193	0	0	0	0	0
OFR: Processing applications from flow	0	0	196,606	196,606	196,606	196,606	196,606	196,606	196,606	196,606
OFR: Costs of processing further information	0		250,510	250,510	250,510	250,510	250,510	250,510	250,510	250,510
Total cost of OFR	**1,408,523**	**1,408,523**	**1,392,070**	**1,392,070**	**1,392,070**	**572,877**	**572,877**	**572,877**	**572,877**	**572,877**
Total Cost/Benefit	**8,768,460**	**8,768,460**	**8,784,913**	**123,024**	**123,024**	**942,217**	**942,217**	**942,217**	**942,217**	**942,217**

Total benefit over 10 years:	**31,278,967**

Non-monetised costs and benefits of the OFR to fund operators (out of scope)

7.91 Fund operators will benefit from a much more streamlined application process when compared to s.272. Subject to an equivalence determination, the OFR would ensure they can continue with their existing product offering and continue to launch new products. The details of the OFR application process are yet to be determined by the FCA. However, given that the equivalence determination will confirm that the funds offer equivalent investor protection, and the use of self-certifications, it is anticipated that the costs of the application process for fund operators would be similar to the existing costs for passporting, and found support for this estimate in the consultation

on this measure. This would represent a significant saving for funds, as the cost of application per fund could be up to 100 times lower when compared to s.272 (as per paragraph 7.42).

7.92 Operators may face some costs under the OFR if the fund has to comply with additional requirements. As HM Treasury has not yet determined which additional requirements would apply to overseas funds (this will be done when an equivalence determination is made), the precise costs of such requirements cannot be quantified.

7.93 Since the aim of additional requirements is to promote comparability with UK funds, they would be based on existing aspects of the UK regulatory framework, and would therefore have been subject to a full cost benefit analysis (either by the Government or the FCA) when they were originally designed. Consideration would be given at the time whether a further cost benefit analysis was necessary, given the nature and impact or any additional requirements. It is important to note that the FCA can, in practice, already insist on additional requirements as a condition of recognising funds under s.272, so the overall impact on individual funds across these two options is likely to net to zero.

Non-monetised benefits of the OFR to investors

7.94 The OFR will create a mechanism by which EEA and other overseas investment funds can, subject to an equivalence determination by HM Treasury, access the UK market. Allowing overseas funds to access the UK market will in turn increase consumer choice. This will drive effective competition in the market, which should result in better value and more innovative products for consumers and institutional investors.

7.95 In the short term, the OFR could allow the existing 'stock' of EEA funds to continue marketing in the UK, which means firms do not have to discontinue these products (impacting on consumer choice), or set up 'mirror' funds (potentially triggering tax liabilities for investors). In general, the OFR will allow UK investors to access investment products domiciled in other countries, which is particularly relevant for certain types of funds which currently are provided almost exclusively from the EU. By radically reducing the costs to both fund operators and the FCA (when compared to the baseline option) the OFR will also avoid considerable costs being transferred to end investors.

7.96 The vast majority of MMFs which are active in the UK are domiciled in the EU and access via the passporting regime. For example, the Institutional Money Market Funds Association, the trade association representing the EU MMF industry, reported that its members have 30 umbrella funds and 79 sub-funds marketing in the UK; as of April 2020, just two of these are UK-domiciled. As MMFs offer a cash management function to institutions, providing an alternative to bank deposits, it is important that UK institutional investors continue to have access to a broad range of MMFs.

7.97 Similarly, there are very few ETFs domiciled in the UK. Although many ETFs are domiciled in the EU, they are often listed on the London Stock Exchange, and need to continue having recognised status in order to be listed. ETFs are a growing part of the asset management sector and have recently been utilised by a number of online investment management firms to provide low-cost services to retail investors.

Small and Micro Business Assessment (SaMBA)

7.98 The main impacts of the OFR are on overseas asset managers, which are typically large businesses, and the FCA.

7.99 Investment funds are often are sold by Independent Financial Advisor's (IFAs), many of whom are small or micro enterprises. Subject to an equivalence determination which would enable the existing product range in the UK to be maintained, the OFR would minimise the impact on these businesses.

7.100 The overall impact on small and micro enterprises is therefore expected to be negligible.

Wider Impacts

7.101 There are no wider impacts associated with this measure.

Summary

7.102 This policy will introduce two equivalence regimes for overseas funds for both retails funds and MMFs. This will enable a streamlined registration process for funds falling within an equivalence determination.

7.103 Based on the calculations in the impact assessment, this delivers a considerable net benefit to the FCA, when compared to the baseline "do nothing" option of using s.272, estimated at around £29,000,000 over 10 years (Table 7.7). This in turn avoids considerable costs from being passed to businesses and ultimately, investors.

7.104 As explained in the methodology, this impact assessment compares the OFR to the baseline where overseas funds are marketing through s.272. The impact assessment does not compare the OFR to the current passporting regime, which will end at the end of the Transition Period. Therefore, the estimated saving related to the theoretical baseline, rather than existing costs. Since the passporting regime is a simple notification regime, it is expected that the FCA will incur some costs of setting up and operating the OFR.

Description of Implementation Plan

7.105 The Government intends to implement this through the Financial Services Bill. Once the Bill has received Royal Assent, The Government will begin the process of assessing countries or territories for equivalence and work with the FCA to smooth funds' transition from the existing TMPR to the OFR, where there is an applicable equivalence determination in place.

7.106 The TMPR is being extended by a statutory instrument made under the EU Withdrawal Act 2018 from the original 3 years, to 5 years (ending in 2025), allowing sufficient time for any assessment of the EU as a whole or as individual member states, a statutory instrument for an equivalence determination, and changes to FCA rules to reflect any additional requirements.

Maintaining the effectiveness of the Financial Services regulatory framework and capital markets

Changes to the FCA's cancellation of authorisation process

Problem Under Consideration

8.1 Firms carrying out a financial services activity as defined by the Financial Services and Markets Act 2000 (Regulated Activities Order) 2001 must be authorised to do so in the UK by either the FCA or the PRA under part 4A of FSMA or be exempt from authorisation.

8.2 The FCA will only authorise a firm under Part 4A of FSMA where it meets the Threshold Conditions. These conditions include the firm being able to be effectively supervised by the FCA and the firm's suitability to conduct the relevant business. Firms must continue to meet the Threshold Conditions to retain their authorisation.

8.3 Authorised firms are required to give the FCA prompt notice if they intend to cease carrying on one or more regulated activities permanently. If the FCA suspects a firm has ceased a regulated activity, the FCA spends significant time seeking to gather evidence from the firm to build a clear picture that it is failing to meet one or more of the existing conditions, in order to exercise its cancellation power. The FCA estimates that, at any point in time, the number of authorised firms no longer carrying on regulated activities, without themselves having sought cancellation of their authorisations, is around 300 to 400.

Rationale for Intervention

8.4 To support public trust and transparency in financial services the FCA is required to keep a publicly accessible record that includes all the firms that are, or have been, authorised by either the PRA or the FCA. The FCA does this online via the Financial Services Register (the Register).

8.5 The Register allows consumers to check that firms offering financial products and services are authorised, as well as those firms' contact details and the products and services they are authorised to provide, and whether those firms, or certain individuals at the firms, have been sanctioned or had other action taken against them.

8.6 The accuracy of the Register is integral to ensuring consumers considering a financial product or service have the required information to take informed decisions about who they deal with. One of the risks an inaccurate Register poses to consumer protection is that fraudsters clone inactive firms on the Register to scam consumers. Improving the speed with which the FCA can cancel the authorisation of a firm that is no longer carrying on regulated activities and reflect this on the Register will help to manage that risk. It will also allow the FCA to use resources more efficiently to better and more swiftly deliver in the public interest.

Policy Objective

8.7 This change will establish a new streamlined process for the FCA to cancel the authorisation of inactive firms and remove them from the Register.

Description of Options Considered

8.8 **Option 0: Do Nothing**: if inactive firms remain on the Register criminals use these to clone such firms and con consumers. The longer it takes the FCA to remove inactive firms, the higher the risk of exposure for consumers to such activity.

8.9 **Option 1: (Preferred option) – streamlining the process by which FCA can cancel an inactive firms' authorisation, through the Financial Services Bill.** This will streamline the process for deauthorising firms that the FCA believes are no longer carrying on a regulated activity to which the authorisation relates, through changes to FSMA.

Policy Outline

8.10 This measure will introduce a new procedure to allow the FCA to cancel a firm's authorisation under Part 4A of FSMA where it appears that a firm is no longer carrying on a regulated activity to which the authorisation relates. This cancellation of authorisation will be reflected in the Register. This includes where a firm has failed to pay a statutory fee to the FCA, file a statutory return with the FCA or provide the FCA with information, including current contact details, required under statute or FCA rules, or repeatedly failed to respond to FCA correspondence.

8.11 This measure does not replace the existing provisions of FSMA relating to the cancellation of firms' authorisations granted by the FCA as described above, rather this new process would slightly modify those provisions, leaving them largely unchanged and still operative in parallel.

Policy Benefits

8.12 This additional process will allow the FCA to streamline cases where they suspect a firm is no longer carrying on regulated activity. This will significantly shorten the time it will take for the FCA to cancel these authorisations and remove these from the Register. In addition, the FCA will be able to redeploy resources currently targeted at building the case for cancellation in regard to these firms, to the public benefit.

8.13 This will ensure that the FCA can keep the Register as up to date as possible, so that consumers considering a financial service or product can take an informed decision. In addition, with fewer inactive firms on the Register there will be less opportunity for fraudsters to clone such firms to defraud consumers. Both consumers and firms will therefore benefit from this additional process.

Policy Costs

8.14 There are no EANDCB costs associated with this measure as the businesses impacted by this measure are either fraudulent or inactive.

Small and MicroBusiness Assessment (SaMBA)

8.15 This amendment does not place any additional obligations upon legally operating businesses of any size.

8.16 To provide additional protection for consumers (which could include small and micro businesses), the Government proposes to allow the FCA to initiate restoration of a firm's authorisation on the firm's application, or on the FCA's own initiative where there is evidence indicating significant potential consumer detriment.

Wider Impacts

8.17 There are no wider impacts associated with this measure.

Summary

8.18 Firms authorised to carry on regulated activities are required to give the FCA prompt notice if they intend to cease carrying on one or more regulated activities permanently. Where this notification has not been given, the FCA must spend considerable time building a case to support cancellation of this firm's authorisation and remove said firm from the Register. The length of time this takes increases risk to consumers who utilise the Register when considering a financial product or service. By implementing this new cancellation process, the Government hopes to considerably decrease the length of time it takes for the FCA to cancel the authorisation of inactive firms and remove these from the Register, thereby improving the Register as a consumer tool and reducing the risks.

Description of Implementation Plan

8.19 The commencement of the amendments to FSMA will follow at least two months after the Financial Services Bill receives Royal Assent.

8.20 The FCA will set out its proposals for how it will implement these changes, which will provide further detail on the new process.

Amendments to the Market Abuse Regulation

Problem Under Consideration

9.1 The EU Market Abuse Regulation (MAR) came into effect on 3 July 2016. It established a strengthened and expanded civil market abuse regime across the EU. It contains prohibitions on insider dealing, unlawful disclosure of inside information and market manipulation, and provisions to empower the regulators of Member States to prevent and detect these. These measures for preventing market abuse are important for supporting market confidence in the integrity and reputation of the UK market.

9.2 As a result of the European Union (Withdrawal) Act 2018, the MAR will continue to apply in UK law after the end of the Transition Period. To ensure that the existing regime under MAR continues to operate effectively in the UK following EU Exit, the Government made amendments to address deficiencies through the Market Abuse (Amendment) (EU Exit) Regulations 2019 (S.I. 2019/310).

9.3 This measure considers two problems within this regulation:

i. The first provision clarifies who should be holding insider lists. Currently, MAR requires issuers or any person acting on their behalf or on their account to maintain an insider list. This has created uncertainty as to whether third parties acting on behalf of an issuer should be holding their own list or sending it to the issuer to hold – leading to a risk that some of the parties are not maintaining insider lists.

ii. The second provision amends a deadline for issuers making information public. Under MAR, persons discharging managerial responsibilities of an issuer (PDMRs) and persons closely associated with them (PCAs) are required to notify the issuer and the FCA of financial transactions on their own account, which are related to that issuer, no later than 3 business days after the transaction. The issuer is also required to notify the public of any such transactions within the same three-day timeframe, which raises technical challenges for issuers to comply when late notice is given by the PDMRs and PCAs. This also applies under MAR to emission allowance market participants. The Government is aiming to lessen the burden on issuers.

Rationale for Intervention

<u>Insider Lists</u>

9.4 Insider Lists are lists maintained by issuers containing details of each individual who has access to inside information and who is working for the issuer either under a contract of employment or otherwise. Insider Lists are critical to the FCA investigating the unlawful disclosure of inside information and insider dealing. Insider Lists also act as a system and control for issuers to appropriately manage their flows of inside information.

9.5 However, the drafting of MAR as it currently stands has caused some confusion. MAR requires issuers **or** any person acting on their behalf **or** on their account to maintain an insider list. This is at odds with the previous MAD (Market Abuse Directive) regime which required issuers **and** their advisors to maintain insider lists. The different

drafting in MAR has meant that issuer's advisors are not sure if they should be holding their own list or sending it to the issuer to hold. This creates the risk that some of the parties are not maintaining insider lists, which increases the risk of the unlawful disclosure of inside information and persons' insider dealing on that information.

PDMRs

9.6 A PDMR is defined in MAR as a person within an issuer who is (i) a member of the administrative, management or supervisory body of that entity; or (ii) a senior executive who is not a member of any of these bodies who has regular access to inside information relating directly or indirectly to that entity and power to take managerial decisions affecting the future developments and business prospects of that entity.

9.7 Under MAR, PDMRs and PCAs are required to notify the issuer and the FCA of their transactions in any financial instruments related to the issuer. The notifications should be made no later than 3 business days after the date of the transaction. The issuer is then required to notify the public of such transactions again no later than 3 business days after the transaction. This creates a burden for issuers to notify the public as they may only receive the notification from the PDMR on the day they are required to publish the transaction. The FCA receives over 20,000 PDMR notifications a year.

Policy Objective

9.8 The Government is seeking to reduce the risk that some parties are not maintaining appropriate insider lists. The Government is also aiming to reduce the burden on issuers regarding PDMR notifications by introducing a more practical and sensible timetable while preserving timely and transparent disclosure of PDMR transactions to the market.

Description of Options Considered

9.9 **Option 0: Do nothing**. If the Government were to do nothing, it is likely that certain parties would not maintain adequate insider lists increasing the risk of insider dealing. Similarly, if the Government did not implement the PDMR measure the burden on issuers would remain.

9.10 **Option 1: FCA provides regulatory guidance on who is required to maintain an insider list.** While further guidance from the FCA may help reduce the instances of parties not maintaining insider lists when they are required to do so it will not completely remove this risk. There is already 'guidance' in the shape of ESMA Q&A, but that has not been sufficient to provide the necessary clarity and legal certainty required. Furthermore, it does not address the underlying issue – the intention of the Regulation is for issuer "and" advisors to maintain insider lists, but the drafting says "or". To fix this, change to the primary legislation is required.

9.11 **Option 2: (Preferred option) Implementing the MAR amendments through the Financial Services Bill,** as outlined below**.**

Policy Outline

9.12 For insider lists, the proposed amendment would replace ‘issuers or any person’ to ‘issuers and any persons’ in Article 18 of MAR.

9.13 For PDMRS, the proposed measure would mean that all issuers and emission allowance market participants are now required to disclose transactions within two business days being notified by the PDMRs or the PCAs of those transactions.

Policy Benefits

9.14 Clarifying the maintenance of insider lists would reduce the risk that some relevant parties are not maintaining insider lists, and subsequently reduce the risk of unlawful disclosure of inside information and persons’ insider dealing on that information. It will also help provide certainty to market participants on how they should be treating inside information.

9.15 The proposed change to PDMR notifications would reduce the burden on issuers by introducing a more practical and sensible timetable while preserving timely and transparent disclosure of PDMR transactions to the market

Policy Costs

9.16 There are no EANDCB costs associated with this policy since it clarifies the position on who needs to maintain insider lists, and increases the time available to comply with an existing reporting requirement.

Small and MicroBusiness Assessment (SaMBA)

9.17 As above, there are no costs to small or micro businesses associated with this measure.

Wider Impacts

9.18 There are no wider impacts associated with this measure.

Summary

9.19 The policy makes two small changes to MAR to clarify who needs to maintain an insider list and to provide a more sensible timetable for PDMR notifications. The insider list change will result in greater legal certainty for all issuers and their advisors in regards to who is required to maintain an insider list. The PDMR change will impose a more practicable timetable for issuers to publish PDMR notifications, which the FCA receives over 20,000 of a year.

Extending the maximum criminal penalties for market abuse

Problem Under Consideration

10.1 Market abuse defines a situation where investors have been unreasonably disadvantaged, directly or indirectly, by the action of another.

10.2 Market abuse is often split into two different aspects:

i. Insider dealing: where a person who has information not available to other investors makes use of that information for personal gain

ii. Market manipulation: where a person knowingly gives out false or misleading information) in order to influence the price of a share for personal gain

10.3 In the UK, criminal insider dealing is an offence under Part V of the Criminal Justice Act 1993, and criminal market manipulation is an offence under sections 89-91 of the Financial Services Act 2012.

10.4 The FCA works closely with law enforcement agencies and other regulators to combat market abuse and enforce these offences. The Market Abuse Regulation (MAR), which sits alongside the criminal regime provides the FCA powers and responsibilities for preventing and detecting market abuse.

10.5 Currently the maximum sentence for criminal market abuse is 7 years compared to similar economic crimes such as fraud which carry a maximum sentence of 10 years. The aim of this policy is to bring the penalty for criminal Market Abuse in line with other serious economic crimes.

Rationale for Intervention

10.6 A strong market abuse framework is import in safeguarding market integrity and investor protection. The Fair and Effective Markets Review 2015 (FEMR), published by HM Treasury, the Bank of England and the FCA in 2015, identified a culture of impunity in parts of the market, coloured by a perception that misconduct would go either undetected or unpunished – increasing the maximum sentence for market abuse was one of a number of recommendations made to address this issue, as individuals accountability is seen as key in preventing misconduct. The Fair and Effective Markets Review Response[72] was published in 2016 and took forward a series of reforms. The Government is now taking this final step which requires primary legislation.

10.7 Increasing the maximum sentence sends a strong message that perpetrators of market abuse crimes will be held responsible for their actions. Furthermore, market abuse damages trust and reduces the effectiveness of the market. In terms of seriousness and the harm caused to society, market manipulation and insider dealing are comparable to other economic crime offences such as fraud or bribery. Therefore, the

[72] Fair and Effective Markets Review, Bank of England (2016): https://www.bankofengland.co.uk/report/2016/fair-and-effective-markets-review-implementation-report

Government believes the maximum sentence should be equivalent to reflect the gravity of the crime.

10.8 At present there is only be a limited amount of headroom under the maximum sentence for judges to impose an increased custodial sentence in order to mark the seriousness of the offence. Increasing the maximum sentence will allow a greater level of flexibility in such cases. When sentencing, a court will consider the circumstances of the offence and any applicable guidelines. It will also seek to identify any 'aggravating' and 'mitigating' factors which apply to the offence. To date, no criminal market abuse case has been tried which involved a significant number of these aggravating factors, and so no case has yet resulted in a sentence being imposed at the current maximum level of seven years. This does not however preclude the possibility that in the future there will be convictions in a case where there are a larger number of aggravating factors and either a very significant breach of trust by senior individuals and/or sophisticated criminality by organised criminal groups.

Policy Objective

10.9 This measure seeks to reduce the instance of market abuse by increasing associated penalties. This will also ensure that it is treated the same way as similar economic crimes.

Description of Options Considered

10.10 **Option 0: Do nothing**. By failing to act, it is possible that firms could perceive market abuse as a lesser crime, reducing the potential deterrent effect, and increasing the likelihood of market abuse. A Market Practitioner Panel (MPP) noted this in its response to the FEMR consultation and highlighted the importance of holding individuals to account for misconduct, in particular through the possibility of longer jail sentences. Increasing the maximum jail sentence demonstrates that the Government views market abuse as a serious offence that should be treated the same way as other economic crimes.

10.11 **Option 1: Increase the level of fines.** For the same reason, increasing the size of potential fines in isolation is unlikely to achieve the desired policy goals. A Market Practitioner Panel has noted that firms may begin to treat large enforcement fines as a cost of doing business, reducing the potential deterrent effect. They highlighted the importance of holding individuals to account for misconduct in FICC markets, in particular, through the possibility of longer jail sentences, as a way to combat this.

10.12 **Option 2: (Preferred option):** Increasing the maximum sentence for criminal market abuse through the Financial Services Bill, from 7 years to 10 years.

Policy Outline

10.13 This policy increases the maximum sentence for criminal market abuse by amending section 61 of the Criminal Justice Act 1993 ("CJA 1993") and to section 92 of the Financial Services Act 2012 ("FSA 2012").

Policy Benefits

10.14 The Government is committed to strengthening and improving its economic crime regime, of which the market abuse regime forms part. The Government is aiming for consistency in the statutory framework for penalising economic crime and there is currently a difference between the maximum sentence which is available under these Acts, and the maximum sentence on the statute books for economic crime offences other than market abuse.

10.15 Market abuse undermines integrity, reduces public confidence and impairs the effectiveness of the financial markets. The Government therefore considers it comparable to other types of economic crimes such as fraud, and therefore aims to establish an equivalent penalty to ensure that it is clear that the Government takes criminal market abuse offences just as seriously as other types of economic crime offences.

10.16 Increasing the maximum sentences also highlights the seriousness of market abuse and sends a clear message that it will not be tolerated and that individuals who break the law will be held to account.

Policy Costs

10.17 This measure does not have any associated EANDCB costs as the measure applies to individuals rather than businesses.

10.18 The main cost of this measure is the potential extra cost to the MoJ as a result of increased jail time for associated offences. Based on recent historical trends and the average cost of imprisonment, the Government estimates this additional impact to be around £100,000 per annuum. This is a public sector cost and will not impact the EANCB.

Small and MicroBusiness Assessment (SaMBA)

10.19 Small and micro businesses are not expected to be adversely impacted by this measure as this measure is targeted at individuals.

Wider Impacts

10.20 There are no wider impacts associated with this measure.

Summary

10.21 The policy aim is to increase the maximum duration of imprisonment from seven years to ten years, in line with the recommendations of the FEMR report. The Government considers market abuse comparable to other types of economic crimes such as fraud, and therefore aims to establish an equivalent penalty to ensure that it is clear that the

Government takes criminal market abuse offences just as seriously as other types of economic crime.

Description of Implementation Plan

10.22 The provisions will come into force when a commencement order is made, at least two months after Royal Assent. This will allow time for the new sentencing guidelines to be made public. The FCA will publicise the new rules in its regular updates both when the Financial Services Bill is introduced and when the measure takes effect. The Government will engage with the judiciary to ensure that they are aware of the new rules.

Application of money laundering regulations to overseas trustees

Problem Under Consideration

11.1 The Sanctions and Anti-Money Laundering Act 2018 (SAMLA) creates the framework for implementing post-Brexit sanctions and anti-money laundering policy. SAMLA will replace the European Communities Act 1972 (ECA 1972) as the statutory power the UK uses to impose and make changes to the UK's money laundering regulations, currently the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (MLRs).

11.2 The Government has previously relied on the ECA 1972 to make regulations in respect of all UK-linked trusts: unlike SAMLA, the ECA 1972 powers are not limited to conduct in the UK or by UK persons. In order to ensure continued HMRC anti-money laundering/counter-terrorist financing supervision of UK-linked trusts based outside the UK, and to ensure the UK can easily update the MLRs in relation to trusts in future, SAMLA needs to have clear extra-territorial application.

Rationale for Intervention

11.3 Once SAMLA is commenced at the end of the EU Exit transition period, and the ECA 1972 repealed, there will be uncertainty at best about HMRC's ability to take enforcement action against non-UK trustees of trusts based outside of the UK. For example, an overseas trust that incurs a UK tax consequence must currently register with HMRC's Trust Registration Service.

11.4 If SAMLA is not amended, any HMRC action to require the registration of these trusts will face a high risk of legal challenge from relevant overseas trustees. The transposition of the EU's Fifth Anti-Money Laundering Directive's provisions in relation to trusts will also (subject to the outcome of a recent consultation) require non-EU resident express trusts that acquire UK land or property, or enter into a new business relationship with a UK obliged entity, to register with HMRC. This makes it more likely that HMRC will be challenged by overseas trusts if SAMLA is not amended.

Policy Objective

11.5 This amendment is a technical amendment to a replacement statutory power that clarifies the continued ability of HMG to enforce and continue to make changes to extra-territorial trust registration powers.

11.6 This will help the UK to continue to improve beneficial ownership transparency and cements HMRC's power to access information on who really owns, and benefits from overseas trusts with links to the UK.

Description of Options Considered

11.7 **Option 0: Do nothing**. Without action there is a risk that HMRC will face legal challenge by overseas trusts.

11.8 **Option 1: Remove UK-linked trusts from the register where the trustees are non-UK persons operating overseas.** This would mean the UK is unable to see who is benefitting from trusts which may contain UK-based assets (subject to the outcome of a recent consultation) or generate a UK tax consequence.

11.9 **Option 2 (Preferred option): Amend SAMLA legislation through the Financial Services Bill**, as set out below.

Policy Outline

11.10 The Government will amend paragraph 22 of Schedule 2 to SAMLA. The amendment will clarify the power for the Government to amend and enforce the MLRs in respect of UK-linked overseas trustees.

Policy Benefits

11.11 Implementing this legislation will help the UK to continue to improve beneficial ownership transparency and cements HMRC's power to access information on who really owns, and benefits from overseas trusts with links to the United Kingdom. This will reaffirm the UK's global leadership in the use of public registers of beneficial ownership, as identified by the Financial Action Taskforce's Mutual Evaluation of the UK in 2018. This will further support the public and private sectors to efficiently and effectively target their resources towards potential criminal activity using trusts, maintaining the resilience of the UK's defences against economic crime.

Policy Costs

11.12 The Government does not expect there to be any costs associated with this measure as the legislation makes a small clarification regarding existing powers.

Small and MicroBusiness Assessment (SaMBA)

11.13 As above, there is expected to be no impact on small and microbusinesses.

Wider Impacts

11.14 No wider impacts are associated with this measure.

Summary

11.15 This amendment is a technical amendment to a post EU-exit statutory power in the Sanctions and Anti Money Laundering Act 2018. It will clarify the continued ability of the Government to enforce and continue to make changes to extra-territorial trust registration powers.

11.16 This will help the Government to continue to improve beneficial ownership transparency and cements HMRC’s power to access information on who really owns, and benefits from overseas trusts with links to the United Kingdom.

Statutory Debt Repayment Plan

Problem under consideration

12.1 There is currently no statutory debt solution focussed entirely on repayment in England and Wales. Existing statutory debt solutions for individuals are all forms of insolvency: bankruptcies, individual voluntary arrangements (IVAs), and debt relief orders (DROs). Early analysis by the Money and Pensions Service (MaPS) suggests that levels of problem debt will rise as a result of COVID-19 and there will be a substantial increase in need for debt advice and debt solutions.

12.2 Debt Management Plans (DMPs) are an existing non-statutory debt repayment solution. Analysis produced for MaPS suggests that DMPs are the UK's most popular debt solution.

12.3 The non-statutory nature of DMPs presents barriers to full repayment of debts, which is sub-optimal for debtors, debt advice providers, and creditors. The costs of these barriers include a sub-optimal repayment rate for creditors, repeat demand for debt advice amongst people whose DMPs do not run to completion, and barriers to getting onto a stable financial footing for debtors.

12.4 Debt advice providers who shared data used in producing this impact assessment suggested that approximately a third of DMPs end prematurely. On average, creditors receive a 50% repayment rate from these DMPs, whereas those that reach completion offer a higher repayment rate.

Rationale for intervention

12.5 A statutory debt repayment solution that is flexible and accommodates repayments over a realistic timeframe would address these problems. This would promote higher repayment rates for creditors, more sustainable solutions for debtors, and more capacity in the debt advice sector.

12.6 The Statutory Debt Repayment Plan (SDRP) addresses this gap in the market for a statutory debt repayment solution. The SDRP is forecast to address the barriers to completion of DMPs. This will increase creditor recoveries, improve the wellbeing of people in problem debt, and increase capacity in the debt advice sector to serve new debt advice clients.

Policy objective

12.7 The objective of the SDRP is to support people in problem debt to return to a stable financial footing by increasing the completion rate of debt repayment plans. This is in addition to wider action the Government is taking to support people in problem debt, including having agreed that funding for debt advice in 2020-21 will rise by over 15%. This will deliver free debt advice sessions to over 580,000 people in England alone. More recently, the Government has announced £37.8m of additional funding for the

provision of free-to-consumer debt advice in 2020-21 to support those in financial hardship due to COVID-19.

Description of options considered

12.8 **Option 0: Do nothing**. DMPs offer a sub-optimal repayment rate to creditors by imposing barriers to plan completion for debtors. These barriers are driven by the flexibility afforded to creditors to demand changes to repayment plans and to reject flexibilities, such as payment holidays, requested by debtors.

12.9 **Option 1 (preferred option): delivering the SDRP through the Financial Services Bill**. The Financial Services Bill will provide the full range of powers to deliver the SDRP effectively. It does not, of itself, deliver any part of the SDRP; rather, it provides the powers that will be used to legislate for the delivery of the SDRP in due course. It does this by amending the Sections 6 and 7 of the Financial Guidance and Claims Act 2018.

12.10 No primary stage SDRP impact assessment accompanied the Act, so this impact assessment uses policy detail set out in the Government's June 2019 Response to a Policy Proposal on the Breathing Space Scheme as a proxy for potential impacts of the scheme.[73] This impact assessment therefore has a broader scope than the amendments to the Act delivered by the Financial Services Bill.

Policy outline

12.11 The Government has continuously increased funding for debt advice over recent years, and in 2020-21 by over 15%. This support will help debt advice providers deliver advice to an estimated 600,000 more people in 2020-21 and 400,000 in 2021-22.

12.12 Increasing debt advice supply by 5.4% per annum between 2017-18 and 2024-25, with the addition of support for an additional 600,000 people in 2020-21 and 400,000 people in 2021-22, suggests that 2.7 million people will receive debt advice in 2024-25, the year in which the regulations establishing the SDRP are assumed to come into force.

12.13 The SDRP will be available in England and Wales. As set out in the June 2019 consultation document, the Government will continue to work with the Department for Communities and Department for the Economy in Northern Ireland to consider the introduction of an equivalent scheme in Northern Ireland. There is an existing Debt Arrangement Scheme in Scotland.

[73] HM Treasury (2019) *Breathing space scheme: consultation on a policy proposal.* Available here: https://www.gov.uk/government/consultations/breathing-space-scheme-consultation-on-a-policy-proposal

SDRP caseload

12.14 The SDRP will be accessible only via professional debt advice. It will be accessible only to people who need a debt solution and then only to those who can repay their debts in full over a reasonable timeframe and, in any case, within ten years.

12.15 The Government has continuously increased funding for debt advice over recent years, and in 2020-21 by over 15%. The Government has gone further in response to COVID-19, providing an additional £37.8m to debt advice providers in 2020-21 so they can continue to provide essential debt advice services and help more people who are struggling with their finances due to the pandemic. This support will help debt advice providers deliver advice to an estimated 600,000 more people in 2020-21 and 400,000 in 2021-22.

12.16 Debt advice supply is forecast to increase by 5.4% per annum. 2.7 million people are expected to receive debt advice in 2024-25, when the regulations that will establish the SDRP are assumed to come into force.

12.17 The growth rate of the SDRP caseload will be determined partly by the rate at which take-up of debt advice increases. Where the limiting factor in this growth rate is supply, take-up rises when supply is increased. When the limiting factor is demand, take-up rises when new demand is induced.

12.18 As the independent 2018 Wyman Review of the funding of debt advice set out, demand for debt advice has tended to exceed supply. The Government's aim is to ensure people who seek debt advice have access to the support that they need.

12.19 When the Government realises its ambition to meet demand by increasing supply, the limiting factor will become demand. The growth rate of demand is unknown, but likely to be lower than that of supply. It is assumed to be 2% per annum. This central assumption has been agreed with the debt advice providers who engaged with the development of this impact assessment.

12.20 The point at which supply of debt advice exceeds demand is highly uncertain, given it is heavily dependent on macroeconomic conditions. It is assumed that the debt advice supply will exceed demand in 2024-25: debt advice take-up is expected to increase at 5.4% per annum up to this point and 2% per annum beyond then.

12.21 The SDRP is a new debt solution. Evidence shared by debt advice providers who supported the development of this impact assessment suggests that 60% of debt advice clients are recommended a recognised debt solution, defined either as a DMP or a form of insolvency. It is assumed that only those who are recommended a debt solution in the counterfactual will be recommended an SDRP.

12.22 This primary stage impact assessment assumes that the SDRP caseload is made up entirely of people who would have entered a DMP in the counterfactual. This underestimates the caseload as some people who will enter an SDRP would have entered an insolvency solution or no recognised solution at all in the counterfactual.

12.23 Evidence shared by debt advice providers who supported the analysis underlying this impact assessment suggests that DMPs make up 33% of debt solution recommendations.

12.24 In the 2019 Breathing Space Scheme policy consultation document, the Government set out that only people able to repay their debts in fewer than ten years would be eligible to enter an SDRP. Evidence shared by debt advice providers who supported the analysis underlying this impact assessment suggested that 84% of DMPs last ten years or less.

12.25 People in problem debt do not always follow the recommendations of their debt advice provider. Debt advice providers who shared evidence to inform this impact assessment suggested that between 51% and 85% of people follow recommendations to enter DMPs.

12.26 51% is taken to be the central estimate for the rate at which people will follow recommendations to enter SDRPs. This is likely to be the case because, though the Government aims to reduce the friction associated with entering an SDRP as much as possible, it is likely to be more difficult to enter an SDRP than a DMP, because the former is a statutory debt solution.

12.27 An optimism bias adjustment is overlaid, to account for the uncertainty in this caseload forecast. The expert judgement of debt advice providers who supported the analysis underlying this impact assessment was that the uncertainty tended towards over-estimation of the caseload. For that reason, the caseload is reduced by 20%. To account for lag time as debt advice providers respond to the introduction of the SDRP, the flow caseload has been halved in year one.

12.28 The total SDRP caseload in any one year will be a product of both new SDRPs that start in that year (flow) and existing SDRPs that are ongoing in that year (stock).

12.29 The SDRP caseload is assumed to behave in the same way as the Debt Payment Plan (DPP) caseload in Scotland, which is the nearest comparable policy to the SDRP. The median DPP duration is six years. Some DPPs end before completion.

12.30 These assumptions dictate the annual SDRP stock caseload, illustrated below. The stock caseload rises until there are six complete years of flow, reaching a steady state in 2031-32. Beyond this point, the caseload is assumed to grow at the same rate as take-up of debt advice: 2% per annum.

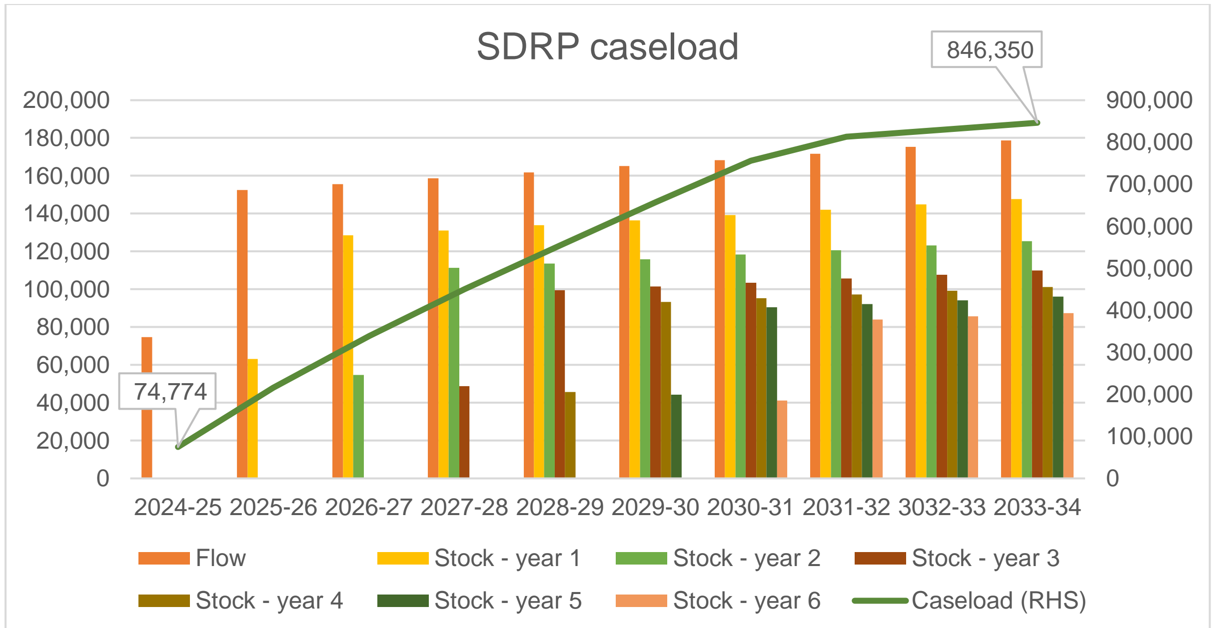

Chart 12.1: SDRP stock caseload across the impact assessment period.

12.31 The annual benefit to creditors and to debt advice providers is based on the number of SDRPs that are projected to terminate in each year of the assessment period. This figure is the difference between the number of SDRPs that are ongoing during each year and at the beginning of the next year. The number of SDRPs that remain at the end of each year is taken to be the sum of the flow in that year and the stock from the previous year.

Benefit to creditors

12.32 Creditors will benefit from higher repayments from people in SDRPs than from people in DMPs. This is because the barriers to completion of SDRPs are lower than those of DMPs and so the mid-plan failure rate in SDRPs will be lower than in DMPs. More SDRPs than DMPs will reach completion.

12.33 Debt advice providers who engaged in the development of this impact assessment suggested that 66% of DMPs reach completion, 33% through early settlement and 33% because their DMP has run its course.

12.34 In Scotland, debtors have access to both DMPs and Debt Payment Plans (DPPs), which are comparable to SDRPs. The DPP completion rate is 15% higher than that of Scottish DMPs, so this impact assessment assumes that the same will be true of SDRPs.

12.35 While this suggests that more SDRPs will reach completion by running their course than DMPs, there is no reason to believe that the completion rate of SDRPs by early settlement will be different to that of DMPs. The rate of completion of SDRPs by early settlement is therefore expected to remain 33%.

12.36 The sum of these two figures, 38% and 33%, suggests that the completion rate of SDRPs will be 71%. This is five percentage points higher than the 66% completion rate of DMPs.

12.37 Not only will more SDRPs end successfully than DMPs; the repayment rate will be higher in these SDRPs than in equivalent DMPs. Debt advice providers who engaged with the development of this impact assessment suggested that the average repayment rate in DMPs that end successfully is 73%. In SDRPs, the repayment rate in completed plans is expected to be 100%, as they are a full repayment solution. This will be confirmed in the final stage impact assessment.

12.38 As the SDRP caseload is made up of people who would have entered DMPs in the counterfactual, the average debt in SDRPs is assumed to be the same as that in DMPs. Debt advice providers who engaged with the production of this impact assessment suggested that this debt level should be £24,246. SDRP clients are assumed to have the same debt level as this.

12.39 This suggests that the amount of debt repaid in an average DMP that ends successfully will be £17,700, £6,546 lower than the equivalent amount repaid in an SDRP than ends successfully. This suggests that creditors will benefit substantially from successful SDRPs relative to successful DMPs.

12.40 29% of SDRPs will not end successfully, meaning that creditors will not receive 100% repayment. The repayment rate in these plans is assumed to be the same as in DMPs that do not end successfully: 50%. This means that there is no marginal cost to creditors in respect of SDRPs that do not end successfully.

12.41 71% of SDRPs that terminate in each year of the assessment period are assumed to have ended successfully. The £6,546 marginal benefit per debtor is applied in respect of these SDRPs. This is a gross benefit to creditors, who will also incur costs, which are assessed below.

12.42 Creditors are therefore expected to benefit from higher repayment in SDRPs than in equivalent DMPs. In present value, this benefit is estimated to be £2,822.7m.

Benefit to debt advice providers

12.43 The SDRP will benefit debt advice providers by reducing duplicate demand for debt advice. There may be additional administration costs to debt advice providers relative to DMPs, although this will be offset by the income debt advice providers will receive under the SDRP funding model. This impact will be assessed in the final stage impact assessment.

12.44 Debt advice providers who engaged in the development of this impact assessment estimated that 24% of debt advice clients whose DMPs fail subsequently enter another solution, doing so immediately and with the same debt advice provider.

12.45 This figure is likely to be a substantial underestimate. It excludes people who go from a failed solution to a new solution but administered by another debt advice provider, as well as those who disengage with debt advice after the failure of their debt solution, but subsequently return.

12.46 As set out in paragraph 12.36 the success rate of SDRPs will be five percentage points higher than that of DMPs. This will mean that fewer people will require duplicate debt advice to help them find another solution after their original solution fails.

12.47 Debt advice providers who engaged in the development of this impact assessment estimated the cost of delivering debt advice to be £289 per client. The benefit to debt advice providers is equivalent to the reduction in the number of duplicate debt advice clients, multiplied by the cost of delivering duplicate advice to those clients.

12.48 To monetise this benefit, the number of annual SDRP terminations is multiplied by the marginal completion rate relative to DMPs. This is multiplied by 24%, to account for the fact that not all debtors whose repayment plans end in failure receive duplicate debt advice. This yields the reduction in duplicate debt advice sessions. This figure is multiplied by £289 to monetise the saving.

Benefit to debtors

12.49 Debt advice providers are expected to benefit from reduced repeat demand for debt advice. This impact is expected to deliver a saving of £1.9m in present value terms.

12.50 People in problem debt who receive debt advice experience a range of benefits. Many of these benefits are not monetised in this impact assessment. Those benefits include: lower dependence on state-subsidised housing; more positive education and employment outcomes; lower risk of children being taken into care; lower rates of desperation crime, and others.

12.51 This impact assessment monetises a much narrower range of benefits to debtors, set out in Table 12.1 below. These benefits are derived from a report by Europe Economics for MaPS' precursor, the Money Advice Service.

Benefit	Upper value	Lower value	Average value
Lower rates of depression	£134	£71	£102.50
Lower rates of anxiety	£36	£21	£28.50
Lower rates of panic attacks	£52	£25	£38.50
Higher debtor wellbeing	£846	£635	£740.50
		Sum	£910

Table 12.1: *Benefit to people in problem debt of being in debt solutions.*

12.52 The base year of this impact assessment is 2024-25. Uprating these benefits from £910 in 2021-22 prices to 2024-25 prices suggests that the benefit to debtors of improved wellbeing because of being in a debt solution is £972. This is a one-off benefit.

12.53 The counterfactual outcome of the SDRP caseload is assumed to be a DMP. As DMPs are a form of debt solution, the SDRP caseload would have experienced some of this £972 benefit in the counterfactual.

12.54 The average repayment rate of DMPs that terminate before completion is 50%. Assuming a constant monthly rate of repayment, this suggests that plans that do not end successfully terminate approximately halfway through their course.

12.55 The £972 benefit applies in respect of debt solutions that run to completion, as clearly debtors whose solutions fail continue, to some extent, to experience the costs of problem debt.

12.56 It would not be proportionate to undertake the primary research necessary to identify exactly what proportion of the £972 benefit is lost when a DMP fails halfway through its expected course. If 50% of the debt has been repaid at the point of failure, the debtor is left to manage the outstanding 50% of their original debt alone. As their debt value has halved, it is assumed that the benefit of being in a debt solution is also halved.

12.57 The completion rate of SDRPs will be higher than that of DMPs. Therefore, more people in problem debt will experience the full £972 benefit. The marginal benefit of the SDRP to this group is therefore £486.

12.58 In present value terms, the benefit to people in problem debt of improved wellbeing is expected to be £13.9m.

Cost to creditors

12.59 As set out in the June 2019 consultation document, 10% of a debtor's monthly payments will be provided to the organisations that operate the plan. This funding model ensures that plans remain sustainable to operate for debt advice agencies, whilst providing fairness to creditors.

12.60 Of this 10% of monthly repayments, 8% will be provided for ongoing administration of an individual's plan. This funding will be available to FCA-regulated and exempt debt advice agencies. 1% will be provided for payment distribution. This funding will be available to debt advice agencies with the relevant FCA permissions to handle client money, or to the Insolvency Service. 1% will be provided to the Insolvency Service for providing administrative oversight of the scheme.

12.61 If creditors contributed 10% of monthly repayments in DMPs to fund the administration of those solutions, there would be no marginal cost to creditors. Debt advice providers who contributed to the development of this impact assessment suggested that the true figure was between 8% and 11%.

12.62 The average disposable income of SDRP clients is expected to be £237. This figure is based on evidence shared by debt advice providers. It is assumed that debtors contribute their entire disposable income to SDRP repayments. This assumption will be reviewed in the final stage impact assessment. This suggests that creditors will forego £23.70 per month in respect of each debtor in an SDRP.

12.63 Creditors are not expected to be required to make systems change or undertake additional administrative tasks in response to the SDRP. This is because the SDRP is not expected to introduce new burdens on creditors that are additional to those relating to DMPs. This assumption will be reviewed in the final stage impact assessment, when the SDRP processes have been finalised.

12.64 Creditors and debt advice providers will incur familiarisation and dissemination costs. These costs will be assessed in the final stage impact assessment. It has not been possible to assess them here as the SDRP regulations and guidance have not yet been written, so their length and complexity – and so the familiarisation and dissemination costs – are unknown.

Small and Micro Business Assessment

12.65 It is too early in the development of the policy to assess what the impact of the policy on SMBs will be, as potential mitigations remain under consideration. For example, the Government set out in paragraphs 5.25 to 5.31 of its June 2019 consultation document that some debts would be repaid more quickly than others. A Small and Micro Business Assessment will be completed in the final stage impact assessment, alongside the necessary secondary legislation.

Description of implementation plan

12.66 This impact assessment provides an estimate of the substantial net benefits of the SDRP, subject to the effective implementation of the policy.

12.67 The Government is working closely with the Insolvency Service to implement both parts of the Breathing Space Scheme – the SDRP and breathing space – and to do so with regard to the advice provided by MaPS in accordance with section 6(4) of the Financial Guidance and Claims Act 2018.

12.68 This advice sets out how HM Treasury may raise awareness of the scheme amongst stakeholders with a role in delivering the scheme and amongst people in problem debt who might benefit from it. The implementation plan will be set out in more detail in a final stage impact assessment, alongside the necessary secondary legislation.

Post-implementation review plan

12.69 The Government will publish a Post-Implementation Review within five years of the commencement of the SDRP, in accordance with section 28 of the Small Business, Enterprise and Employment Act 2015.

12.70 The Post-Implementation Review plan will be set out in more detail in a final stage impact assessment, once the secondary legislation has been finalised. This will include setting out the Government's approach to ongoing monitoring and publication of official statistics and administrative data on the SDRP, in accordance with the MaPS advice.

Successor accounts for Help-to-Save accounts

Problem Under Consideration

13.1 The Help-to-Save scheme was introduced to support working people on low incomes and in receipt of certain benefits build up a 'rainy day' fund, while also encouraging the development of a long-term savings habit. 22% of the working population have less than £100 in savings[74] , and 12% of the UK population have no savings or investments at all[75]. Since the launch of the scheme in September 2018, over 222,000 people have opened Help-to-Save accounts, with over £85m deposited.

Rationale for Intervention

13.2 The existing legislation is silent on what happens to any savings in a Help-to-Save account at maturity, particularly where the account holder does not provide instructions to the account provider. The account provider is the statutory officer known as the Director of Savings, who provides the accounts through the operations capability of National Savings and Investments/NS&I. NS&I has a dual status as a non-Ministerial government department and an executive agency of the Chancellor of the Exchequer. Without instructions the funds in the account cannot be paid to the account holder or moved to another account.

13.3 The Government wishes to ensure that any funds held in mature Help-to-Save accounts are retained within a savings environment in the absence of instructions from the account holder. There is currently no provision in the relevant legislation or individual contracts setting out what happens to these accounts at maturity. Allowing such accounts to become dormant by default would undermine the dual policy objectives of helping people to build a financial buffer while encouraging a long-term savings habit.

Policy Objective

13.4 The Help-to-Save scheme was introduced to support working people on low incomes and in receipt of certain benefits to build up a rainy-day fund, while also encouraging the development of a long-term savings habit. Help-to-Save accounts can be opened by individuals in receipt of Working Tax Credit, or Universal Credit with weekly earnings equivalent to at least 16x National Living Wage (NLW) (£604.56/month for 2020-21).

13.5 This measure will enable funds held in a mature Help-to-Save account to be transferred by the Director of National Savings (NS&I) to a successor account at maturity, where there have been no instructions to the contrary. This will contribute

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[74] Money Advice Service (2018) Available at: https://www.moneyadviceservice.org.uk/en/corporate/press-release--money-worries-have-left-two-in-three-brits-worried-about-loved-ones-mental-health

[75] FCA Financial Lives Survey 2017. Available at: https://www.moneyadviceservice.org.uk/en/corporate/press-release--money-worries-have-left-two-in-three-brits-worried-about-loved-ones-mental-health

to encouraging a long-term savings habit and will ensure account holders continue to be supported past the full term of the accounts, even where they have not acted to transfer the funds.

13.6 Increasing savings supports stable, long-term economic growth and helps households meet their aspirations and reduces the risk of families falling into financial crisis. The Help-to-Save scheme encourages working people on low wages to save for their future by the provision of a cash incentive. This reflects the fact that tax incentives are less relevant for those on low incomes.

13.7 As stated above, 22% of the working population have less than £100 in savings, and 12% of the UK population have no savings or investments at all. Since the launch of the scheme in September 2018, over 222,000 people have opened Help-to-Save accounts, with over £85m deposited.

Description of Options Considered

13.8 **Option 0: Do nothing**. A non-legislative alternative was considered but it would require the account provider to be prepared to offer a successor account, and for voluntary consent to a transfer on maturity to be obtained from each account holder individually. In addition, without legislation the essential elements of a successor account, could not be prescribed.

13.9 **Option 1 (Preferred option) – Implement the Help-to-Save successor account measure through the Financial Services Bill**. The detail of which can be found below.

Policy Outline

13.10 Account holders may deposit up to £50 per calendar month and, after two years, a 50% government bonus will be paid on the maximum account balance during that period (up to £600 in respect of a maximum £1,200 balance).

13.11 The bonus will be paid into a bank account designated by the account holder. Customers can continue to deposit up to £50 per month for a further two years, and will receive a second 50% bonus on the maximum amount by which the account balance has exceeded the sum on which the first bonus was paid. While the 2nd bonus will also be paid into the designated account, any balance of savings remaining in the account will be retained by the account provider pending instruction from the account holder.

13.12 The first account was opened in January 2018 and the first bonus was therefore paid in January 2020 (after two years). The accounts will begin to mature, and the 2nd bonus paid, in January 2022 (after four years).

13.13 Neither the Savings (Government Contributions) Act 2017 (the "Act"), nor The Help-to-Save Accounts Regulations 2018 SI 2018/87 (the "Regulations") make provision for the status or future of the funds after any second bonus is paid. A new section will be introduced in Schedule 2 of the Act. This will define "matured account" and "successor

account" for the purposes of legislation and make sure that any balance in a matured Help-to-Save account is transferred to a successor account.

13.14 The primary legislation will stipulate that the successor account may be a new or existing account within the National Savings Bank. Regulations will stipulate the mechanism and detail of the successor account in a subsequent Statutory Instrument.

13.15 At present, it is not possible to estimate how many savers will withdraw their funds at maturity, since none have yet matured. This measure will only affect accounts that are not withdrawn at maturity.

Policy Benefits

13.16 The benefits to society (which cannot be quantified) consist of the potential continuation of the savings habit which was instilled while the saver had a Help-to-Save account, in cases where the saver does not take an active decision to save elsewhere. Once the individual re-engages with their account, they will have the option of withdrawing their funds, transferring them to an alternative account or remaining in the successor account.

13.17 Savings are important for financial resilience. Falling into financial crisis can affect an individual's health, strain their relationships and hurt productivity, all of which negatively impact society.

Policy Costs

13.18 The cost of this measure will consist of additional costs incurred by NS&I in making successor accounts available to savers whose Help-to-Save account has matured and who have not withdrawn the capital or provided instructions. This is estimated to be a one-off implementation cost and ongoing changes between January 2022 to September 2027 There will be no costs for businesses as a result of this measure as NS&I will be the only provider for the successor accounts.

Small and MicroBusiness Assessment (SaMBA)

13.19 As this measure is a public sector change, there will be no costs for small and microbusinesses as a result of this measure as NS&I will be the only provider for the successor accounts.

Wider Impacts

13.20 Help-to-Save supports working families on low incomes to build up their savings. Over 3 million individuals are eligible to open an account. The target population has been estimated as 66% female. While many savers will be actively engaged with their account at maturity, it is likely that some will not be. These changes ensure that any savings in a matured account remain in a savings account pending a decision by the saver.

Summary

13.21 The legislation will ensure any money held in mature Help-to-Save accounts is transferred to an accessible savings account where the saver has not given specific instructions to withdraw or transfer the money.

Description of Implementation Plan

13.22 The regulations providing the detail of the successor accounts to be in place by December 2021 before the first Help-to-Save accounts reach maturity in January 2022.

13.23 HM Treasury will monitor the impact of these changes on an ongoing basis using the information provided by, and discussion with, NS&I.

Amendments of the PRIIPs Regulation

Problem Under Consideration

14.1 The Packaged Retail and Insurance-based Investment Products Regulation (the PRIIPs Regulation) (EU No 1286/2014) was introduced across the EU on 1 January 2018 and was implemented in the UK through the Packaged Retail and Insurance-based Investment Products Regulations 2017. As part of preparations for the UK's withdrawal from the EU, the UK Regulations were amended by the Packaged Retail and Insurance-based Investment Products (Amendment) (EU Exit) Regulations 2019, to ensure that the legislation would continue to function effectively in a no deal scenario.

14.2 The Regulation requires all those who manufacture, or provide advice on, certain investment products known as PRIIPs to issue a Key Information Document (KID) when the product is sold to retail investors in the EU. The KID should tell the investor what the product is, the expected risk and return, and the costs associated with holding the product. The KID is also required to display 'performance scenarios' which project predicted performance of the product in a range of scenarios (from 'stress' to 'favourable'), and a summary risk indicator, which ranks the product on a scale of 1-7 based on how risky the product is.

14.3 The PRIIPs Regulation has been widely recognised as flawed by industry and regulators across the EU since its introduction. HM Treasury is proposing that the most pressing issues in the Regulation are amended through the Financial Services Bill:

i). **Scope of the PRIIPs Regulation**: there is uncertainty as to the applicability of the PRIIPs Regulation to certain products. There is therefore significant concern that some products, such as corporate bonds, are being inappropriately treated as PRIIPs due to the definition of a PRIIP in the EU Regulation. There is evidence, for example, that the retail market for corporate bonds has shrunk as a result, as providers withdraw such bonds from the retail market in order to avoid having to produce a KID. HM Treasury is therefore proposing to delegate a power to the FCA to clarify, through their rules, the characteristics that qualify an investment product as a PRIIP.

ii). **Performance scenarios**: performance scenarios have been criticised for producing potentially misleading depictions of performance across nearly all asset classes. The methodology for calculating performance scenarios is based on past performance and can result in overly optimistic projections of returns (including, for example, positive returns in the so-called 'stress' scenario). HM Treasury is therefore proposing to remove the reference to performance scenarios in the retained PRIIPs Regulation and to replace it with a requirement to include 'appropriate information on performance' the KID. The FCA are then, by virtue of powers in The Financial Regulators' Powers (Technical Standards) (Amendment etc) (EU Exit) Regulations and 2018 and The Packaged Retail and Insurance-based Investment Products (Amendment) (EU Exit) Regulations 2019, able to update their technical standards in this area to clarify what 'performance information' should cover.

iii). **<u>Undertakings for the Collective Investment in Transferable Securities (UCITS) exemption</u>**: UCITS funds are currently exempt from the EU PRIIPs Regulation's requirements until 31 December 2021. This exemption will also apply in the UK after exit. The Government is proposing a power to further extend, by regulations, the current exemption date in the PRIIPs Regulation if necessary. This would provide a further transition period for UK and EU UCITS funds to comply with the requirements of the PRIIPs Regulation as amended by the other measures set out above. It will also ensure that UK and EU UCITS sold to UK retail investors will be subject to the same disclosure requirements, thereby improving consistency and comparability of information provided to UK investors.

Rationale for Intervention

14.4 The Government has been made aware of significant concern regarding the PRIIPs Regulation. Some of the concerns, including uncertainty about the applicability of the PRIIPs Regulation to particular investment products, and unintended effects of compliance with the requirements of the PRIIPs Regulation, are particularly serious and may risk causing consumer harm if not addressed. The FCA issued a Call for Input and subsequent Feedback Statement on market participants' initial experiences with the PRIIPs Regulation which identified areas of particular concern from industry.

14.5 Several EU Member States, including France and Germany, have identified the similar concerns with the PRIIPs Regulation and called for changes to be made at the EU level. A Joint Consultation Paper concerning the PRIIPs Delegated Regulation was conducted by the European Supervisory Authorities and closed to responses in January 2020. However, any changes arising from this consultation will not apply to the onshored UK PRIIPs Regulation since they will take effect after the end of the Transition Period. Therefore, to address the aforementioned concerns with the PRIIPs Regulation, it is appropriate for the Government to make legislative changes.

Policy Objective

14.6 The Government supports the objectives of the PRIIPs Regulation, which seeks to enhance investor protection by standardising the disclosure document provided to retail investors when they purchase PRIIPs. However, the Government has been made aware of significant concerns with the PRIIPs Regulation. These unintended consequences undermine the effectiveness of the regime, and may risk consumer harm if not addressed.

14.7 Therefore, the original policy objective of the PRIIPs Regulation remains unchanged as a result of this measure. Retail investors in the UK will still be provided with a Key Information Document when they are sold, or receive advice on, a PRIIP. These measures do not deviate from the original policy intention to provide retail investors with accurate and concise information about the products that they choose to invest in. The policy objective of these measures is to improve a flawed regime, thereby

addressing significant industry and regulatory concern, and improving consumer protection.

Description of Options Considered

14.8 **Option 0: Do nothing**: if no amendments were made to the PRIIPs Regulations, the regime would continue to function, but the issues outlined above would persist. PRIIP manufacturers and firms advising on PRIIPs would be obliged to continue providing retail investors with KIDs that have the potential to be misleading or inaccurate. Given the concerns with the Regulation are well known and UK authorities accept these concerns, there would also be reputational risk for both the Government and the FCA if no action was taken to improve the regime.

14.9 **Option 1: Amend FCA rules**: when the UK leaves the EU, the FCA will be able to make amendments to technical standards implementing the PRIIPs Regulation by virtue of the Financial Regulators' Powers (Technical Standards etc.) (Amendment etc.) (EU Exit) Regulations 2018. This allows the FCA, as the competent authority for the PRIIPs Regulation, to amend some the technical standards that provide further detail as to the requirements of the PRIIPs Regulation. This would allow the FCA to amend, for example, the methodology used to calculate performance scenarios and summary risk indicators.

14.10 However, there is a need to amend the PRIIPs Regulation, in addition to the technical standards, in order to fully address the issues that have been identified. The only way to make these amendments is through primary legislation.

14.11 **Option 2: (Preferred option):** Use the Financial Services Bill to make targeted amendments to empower the FCA to make relevant rules, and to amend the PRIIPs Regulation: the FS Bill is the most appropriate legislative vehicle through which to make targeted amendments to the PRIIPs regulation and to empower the FCA with the appropriate accompanying rule-making powers.

Policy Outline

14.12 The policy makes targeted amendments to the retained PRIIPs Regulation, making the required amendments and clarifications to improve the functioning of the Regulation. These amendments to the PRIIPs Regulation will be followed by changes to the FCA's rules, which will outline in more detail what the requirements on firms will be in relation to 'appropriate information on performance' and the scope of the Regulation. Secondary legislation will also set out the detail of the length of the extension to the UCITS exemption, should HM Treasury choose to use this power.

Policy Benefits

14.13 Benefits will be to retail investors and will mean that those who purchase, or receive advice on, PRIIPs will be less at risk of being supplied with misleading or inaccurate information regarding their investments. PRIIPs manufacturers and advisers will also no longer be obliged to provide information that they may deem misleading or inaccurate.

14.14 Manufacturers of products that are determined to be out of scope as a result of clarificatory rules will be certain that they are not required to produce a KID and therefore some manufacturers may save on the costs incurred to produce a KID.

Policy Costs

14.15 Firms will not be expected to make any changes to their reporting requirements until the FCA make the corresponding rule changes. An estimated 3,000-4,000 PRIIPs manufacturers (UK, EU and third country) operate in the UK and should already be producing KIDs if they sell or advise on PRIIPs. The Government has not yet estimated what proportion of these are involved in cross-border activity (i.e. those that sell PRIIPs to both EU and UK retail investors) and so may be required to produce different KIDs for their UK and EU customers. The cost of producing a KID is estimated to be around £10,000 and the changes proposed are not expected to significantly affect the cost of producing a KID for those in scope of the Regulation. For those firms subject to a dual regime (where, for instance, they have to provide KIDs to both UK and EU retail investors), additional costs are expected to be minimal due to economies of scale and the similarity of the reporting regimes.

14.16 When the FCA publishes the associated rules, firms will face familiarisation costs in relation to these rules. These are likely to be minimal if the regimes are similar in nature.

Small and MicroBusiness Assessment (SaMBA)

14.17 This legislation will apply to activities that are undertaken by small and micro businesses. All manufacturers and advisers on PRIIPs are required to supply the same information to retail investors, regardless of their size. Given that the previous section notes that these changes are not expected to affect the cost of providing a KID, small and micro businesses will not be disproportionately impacted by this measure. It would not be appropriate to lessen investor protection based on the size of the firm they purchase, or receive advice on, PRIIPs from.

Wider Impacts

14.18 There are no wider impacts associated with this measure.

Summary

14.19 This measure makes targeted amendments to the PRIIPs Regulation in the UK to improve its functioning and respond to industry and regulatory concern. They are necessary to: (1) clarify the scope of the regulation, (2) to prevent retail investors potentially being misled by the information provided to them on disclosure documents, and (3) to make provision for a further transitional period for UCITS funds to comply with the requirements of the PRIIPs Regulation as amended by the Bill. The only costs are expected to be negligible and will be incurred amending what is included on a KID, the potential cost of producing two KIDs if a PRIIP is sold to both UK and EU retail investors, and familiarisation costs.

Description of Implementation Plan

14.20 The measures will be implemented through the Financial Services Bill. Further detail of the regime will be implemented through subsequent FCA rule changes (with respect to clarificatory rule changes concerning scope and performance information) and secondary legislation (in respect of a potential extension to the UCITS exemption).

Over the counter derivatives: clearing and procedures for reporting

Problem Under Consideration

15.1 The UK's framework for 'over the counter' (OTC) derivatives was introduced in the European Market Infrastructure Regulation (EMIR) in 2012, which implemented the G20 Pittsburgh commitment that derivatives trades should be centrally cleared and reported to trade repositories (TRs).

15.2 It is the Government's intention to introduce two technical updates to the EMIR framework in the Financial Services Bill. These updates should continue to reduce operational burdens on firms who do not pose as much systemic risk in the derivatives market improve the quality of data reported to TRs and help to increase competition amongst TRs. These updates will thereby improve the functioning of the UK's regulatory regime for derivatives. Specifically, these updates:

i. Ensure that clearing members of central counterparties (CCPs) who offer clearing services themselves, and their clients who offer clearing services indirectly, do so on a fair, reasonable, non-discriminatory and transparent (FRANDT) basis.

ii. Set additional conditions to improve the derivatives data quality which is reported to TRs and ensure thee orderly transfer of data between TRs, where necessary. Four TRs have so far applied to offer services in the UK post-exit, who will be affected.

Rationale for Intervention

<u>Measure 1: FRANDT principles</u>

15.3 The "clearing obligation" was introduced by Article 4 of EMIR and requires that certain classes of OTC derivative contracts must be cleared through a CCP. Most firms captured by the clearing obligation will access clearing via a clearing member or client as this is less burdensome than becoming a clearing member of a CCP. However, relatively few clearing members and clients offer this service, meaning there is little competition to improve prices and services, particularly for firms who need to clear a low volume of transactions. As clearing is a regulatory requirement for some firms, they are not able to simply choose not to use these services. Legislation in this area would help to ensure that services are offered on a fair, reasonable, non-discriminatory and transparent basis.

Measure 2: TR procedures

15.4 A “reporting obligation” was introduced through Article 9 of EMIR and requires that all derivatives contracts are reported to TRs. TR data is primarily used by financial regulators to better understand risk in derivative markets. As there are a small number of systemic firms operating in derivative markets, it is important that regulators can understand any systemic risk which might be developing in these markets, and safeguarding data quality will mean that the FCA, PRA and Bank of England are able to monitor such risks effectively.

15.5 Therefore, this measure will require that TRs put in place procedures for the effective reconciliation of data between TRs and to verify the completeness and correctness of the data reported.

15.6 EMIR also envisages that TRs should operate in a competitive environment. It is therefore necessary for firms to be able to choose and switch between TRs should they wish. It may also be necessary to move from one TR if its registration has been withdrawn. This measure therefore requires TRs to put in place processes for the orderly transfer of data to other TRs where requested by the counterparties or CCPs or where otherwise necessary.

Policy Objective

Measure 1: FRANDT principles

15.7 The Government intends to ensure that clearing members and clients of clearing members that provide clearing services, either directly to other counterparties or indirectly by allowing their own clients to provide those services to other counterparties, are required to do so based on fair, reasonable, non-discriminatory and transparent (FRANDT) principles.

15.8 The FRANDT principles should apply to fees, prices, discount policies, commercial terms and contractual arrangements for the provision of clearing services for OTC derivative contracts which are subject to the clearing obligation under EMIR.

15.9 The measure should not impose an absolute obligation for clearing members and clients to provide clearing services, prevent them from controlling risks associated with the clearing services, or act as a price cap.

Measure 2: TR procedures

15.10 This measure seeks to place obligations on TRs through establishing policies and procedures to effectively reconcile data between TRs; verify the completeness and correctness of the data reported; and transfer data to other TRs in an orderly fashion where necessary. This will ensure that UK regulators are able to monitor systemic risk

in derivatives markets based on improved TR data, along with improving competition amongst TRs.

Description of Options Considered

15.11 **Option 0: Do nothing.** The impacts of failing to act are as follows:

Measure 1: FRANDT principles

15.12 The risk of not improving on the current situation would be that barriers to access central clearing, such as high costs and service ambiguity, continue to exist. As a result, market participants may cease transacting derivatives or engage in non-cleared OTC derivatives trading, which would be contradictory to the efforts made to establish a sound and efficient cleared market and could lead to an increased risk in financial markets.

Measure 2: TR provisions

15.13 As set out above, it is important that regulators have access to timely and comprehensive data from TRs in order to understand systemic risk in derivatives markets. If poor data quality issues persist, this inhibits the regulators' ability to understand any systemic risk which might be developing in these markets. Inaction will also mean a less than optimal environment from a competitiveness standpoint.

15.14 **Option 1 (Preferred option): Legislate to introduce the provisions through the FS Bill**, enabling the FCA to set out further detail in respect of both the FRANDT principles and TR procedures to ensure requirements are appropriate and adaptable to the UK context. The policy benefits to this approach are set out below.

Policy Outline

Measure 1: FRANDT principles

15.15 Article 4 of UK EMIR (EMIR as retained in UK law at the end of the Transition Period) will be amended to introduce these principles. The FCA will be required to produce technical standards, outlining the grounds on which commercial terms will be considered to satisfy FRANDT requirements. The FRANDT principles will not come into force until the FCA has published the relevant technical standards. This empowerment is appropriate for the FCA because, as the regulator, they will be required to enforce the FRANDT terms, which makes it appropriate for them to specify the form and content of these requirements in the first instance.

Measure 2: TR procedures

15.16 Article 78 of UK EMIR will be amended to introduce this provision. In the Trade Repositories (Amendment and Transitional Provision) (EU Exit) Regulations 2018, the

FCA were assigned responsibility for ensuring UK TRs are compliant with EMIR, including this article. This provision places obligations on TRs as set out above and empowers the FCA to set out details via regulator rules about the policies and procedures TRs will be expected to establish. These should be binding on TRs.

Policy Benefits

15.17 The procedures, policies and principles that firms will have to follow as a result of these provisions will be set out in further detail by the FCA. As such, the measure in and of itself, will not create transitional benefits. Any benefits will be derived from the new requirements introduced by the FCA, as set out below, and are therefore hard to quantify at present.

Measure 1: FRANDT principles

15.18 Once the FRANDT principles are in force, and the details are determined by the FCA, firms will benefit from increased accessibility to clearing services.

15.19 Moreover, for those firms trying to access clearing via a clearing member or client, it could reduce the costs, or at the very least the ambiguity, they might currently face concerning service offerings. Overall, improved ease of access to clearing should strengthen incentives to clear centrally and reduce systemic risk.

Measure 2: TR procedures

A key recurring benefit of this measure is therefore increased transparency and reduced risk in derivatives markets from financial regulators having improved data quality. It is also expected that the measure will increase competition between TRs, encouraging lower fees and more choice in the market.

Policy Costs

Measure 1: FRANDT principles

15.20 The FRANDT principles do not come into force until the FCA has published the relevant technical standards. This is to ensure that firms do not adjust their behaviours in anticipation of the requirements set out in the rules. As such, the measure, in and of itself, will not generate EANDCB costs, as changes that clearing members and clients may need to introduce will be determined by the detail of the FCA's publication, rather than anything set out in the primary legislation. However, it is likely that if firms are required to adjust their practices in order to comply with the FRANDT principles this could increase their costs.

15.21 After an initial transition phase pursuant to the FCA's publication of their rules, and any resulting familiarisation costs, the ongoing administrative burden from FRANDT requirements will be more limited.

15.22 For clearing members and clients, there could be a need to provide additional information to the FCA in order to comply with a transparency obligation with respect to fees, prices, discount policies and other contractual terms and conditions. However, the administrative burden would be limited. It is difficult to estimate the number of clearing members or clients who will be impacted by the provision since it does not impose an absolute obligation for clearing members and clients to provide clearing services, and therefore remains a voluntary offering.

15.23 Across all products in all UK CCPS, around 50% of clearing members offer client clearing. It is not possible to exactly quantify the number of clients also offering clearing services, but we estimate that the measure will impact approximately 200 firms in total. These firms are mostly made up of large financial organisations.

Measure 2: TR procedures

15.24 The EU previously produced analysis on the costs of putting in place measures to deal with insufficient quality of data. This included the possibility that reporting counterparties will incur some additional costs and efforts in the initial stages of implementation. These costs will predominantly fall on TRs.

15.25 However, the procedures and policies that TRs will be obligated to implement will be set out in further detail by the FCA. As such, the measure, in and of itself, will not create additional costs.

Small and MicroBusiness Assessment (SaMBA)

Measure 1: FRANDT principles

15.26 The impact of this measure is predominantly on clearing members and clients of clearing members, as they will be required to adjust their practices in order to comply with the FRANDT principles. These firms will not be small or microbusinesses.

15.27 There is the potential that small and microbusinesses could be accessing clearing through clearing members and clients, although data on this is not currently available. In any case, for those businesses who do access clearing this way, FRANDT should be advantageous to them in that it should improve access to clearing and therefore reduce any burdens and barriers they may face. Small and microbusinesses may need to familiarise themselves with the FCA's technical standards, but any additional cost is expected to be negligible.

Measure 2: TR procedures

15.28 The impact of this measure is predominantly on TRs rather than small or microbusinesses. Whilst any impact on smaller firms and microbusinesses will depend upon how the TRs implement the requirements around data quality and portability, the

population of such firms is small, and the impact on smaller firms and microbusinesses is likely to be minimal (if there is any impact at all).

15.29 In many cases, firms would delegate their reporting requirements to their larger financial or non-financial counterparts. From an operational standpoint it would be those larger firms who would take on any possible additional cost. For the smaller firms, there would be an element of checking what their counterparts are reporting on their behalf (including any data quality/portability requirements) but this should already be incorporated within their 'business as usual' processes.

Wider Impacts

15.30 There are no wider impacts associated with this measure.

Summary

15.31 These two provisions allow UK firms and regulators to benefit from technical updates which will further improve the functioning of the UK's regulatory regime for derivatives.

15.32 The primary legislation does not specify what new requirements will be introduced, rather it delegates responsibility to the FCA to determine further technical details. The aim of the primary legislation is to empower the FCA to: outline the grounds on which commercial terms will be considered to satisfy FRANDT principles; to set out procedures for TRs to ensure the quality and transparency of data; and to set out procedures to ensure the orderly transfer of data between TRs where requested.

Description of Implementation Plan

Measure 1: FRANDT principles

15.33 This provision will come into force at least two months after Royal Assent, and only after the FCA has both conducted the public consultation provided under s.138I FSMA; and published the relevant technical standards. This should ensure that firms do not adjust their behaviours in anticipation of any new requirements, which could have unintended but negative consequences for access to clearing.

Measure 2: TR procedures

15.34 This provision will come into force at least two months after Royal Assent, and only after the FCA has both conducted the public consultation provided under s.138I FSMA; and published the relevant rules.

Regulations about financial collateral arrangements

Problem Under Consideration

16.1 Collateral is an asset (such as cash or shares) that a borrower will provide to a lender. Should the borrower default on its loan payments, the lender can then seize the collateral and use it to offset some or all of its losses. Collateral is widely used in financial markets in order to enable different types of transactions.

16.2 In 2002, the EU passed Directive 2002/47/EC on financial collateral arrangements (the "Financial Collateral Directive" or "FCD"). The FCD simplified the process of taking financial collateral across the EU by introducing a uniform legal framework which reduced the formalities required when providing or taking collateral and by facilitating the realisation of the collateral in the event of the collateral provider's default. The FCD applies to financial collateral arrangements entered into by a variety of financial institutions including central banks, investment banks and Financial Market Infrastructures. The FCD therefore covers a variety of transactions such as repurchase agreements, securities lending and derivatives trades.

16.3 As with all EU Directives, Member States must introduce legislation of their own to implement the Directive. The Government did this in 2003 through the Financial Collateral Arrangements (No.2) Regulations ("FCARs"). In order to make the FCARs, the Government exercised powers conferred by section 2(2) of the European Communities Act 1972 ("ECA").

16.4 The FCARs applied to collateral arrangements between all "non-natural persons" (i.e. any institution or business) whereas the FCD required one side of the transaction to be a specific type of financial institution. Subsequent litigation, though it has not invalidated the FCARs, has raised the issue of whether the UK's 2003 transposition went beyond the implementing powers in the ECA, given the provisions within the FCARs were applied to a broader class of persons than the underlying EU Directive.

Rationale for Intervention

16.5 Given the widespread use of collateral in a variety of financial market transactions, it is important that there is no legal uncertainty as to the application of the UK's legal regime. The Government is therefore intervening through this measure to remove any legal uncertainty as to the application of the FCARs.

Policy Objective

16.6 This measure will put the issue beyond doubt and ensure that the FCARs stand on a sound statutory footing by stating that the FCARS are, and always were, valid and fully effective. By extension, any financial collateral arrangements that have been entered into, or will be entered into, in reliance on the FCARs are effective and are not at risk of legal challenge. This provides absolute legal certainty to the financial market participants who enter into collateral arrangements in reliance on the FCARs and avoids any risk of potential future legal challenge on the statutory footing of the Regulations.

Description of Options Considered

16.7 **Option 0: Do nothing.** HM Treasury has considered not legislating in this area. However, this would leave outstanding legal uncertainty as to the application of the FCARs which is detrimental for the firms reliant on the legislation.

16.8 **Option 1: (Preferred option) – Legislating in the FS Bill to remove any legal uncertainty regarding the statutory footing of the FCARs**. By inserting provisions into section 255 of the Banking Act 2009 which confirm that the FCARs, as made in 2003, stand on a valid statutory footing.

16.9 Section 255 also contains existing powers for HM Treasury to make policy changes in relation to financial collateral through statutory instrument laid under the made affirmative procedure. The Government will amend these powers so that the normal draft affirmative procedure will be used, as it believes that this procedure is more appropriate for any future policy changes that it may wish to make in relation to financial collateral through the use of this power as it ensures that Parliament has the opportunity to scrutinise the legislation in advance of it coming into force.

Policy Benefits & Costs

16.10 The measure reaffirms that existing legislation, which is already in use, is valid and fully effective in order to ensure that businesses and markets can continue to operate as they do currently. It does not impose new requirements on firms nor introduce policy changes. The net EANDCB cost of the measure is therefore expected to be zero.

Small and MicroBusiness Assessment (SaMBA)

16.11 Given that this measure is enacting existing behaviour of firms, there are no disproportionate effects anticipated on small or micro businesses.

Wider Impacts

16.12 There are no wider impacts associated with this measure.

Summary

16.13 This measure confirms the validity of the statutory footing of the FCARs in order to ensure legal certainty for market participants. The measure preserves current market arrangements and will not create additional obligations or costs on industry.

Appointment of the Chief Executive of the FCA

Problem Under Consideration

17.1 Currently legislation does not set out a term length for the FCA Chief Executive; instead this is determined by HM Treasury. The Government wishes to provide a statutory basis for the appointment of the FCA Chief Executive to be subject to a fixed, once renewable 5-year term (i.e. any one CEO can only serve two consecutive five-year periods in office). This change will bring the appointment length into line with comparable public appointments, such as Deputy Governors of the Bank of England.

Rationale for Intervention

17.2 The Government committed to making this change to the Treasury Select Committee during the passage of the Bank of England and Financial Services Act 2016 through the House of Commons[76] . The Government also committed to giving the Treasury Committee the statutory role of holding a pre-commencement hearing with the appointee to the post of FCA Chief Executive, and has already enacted this change through an amendment made during the passage of the Bank of England and Financial Services Act 2016 (see paragraph 2A(1)(a) of Schedule 1ZA of FSMA).

Policy Objective

17.3 The Government believes that, as a matter of best practise, and to ensure a high level of transparency and accountability, this appointment should be brought into line with similarly high-profile appointments, such as Deputy Governors of the Bank of England. This is also in line with an existing commitment made to the Treasury Select Committee to legislate to make this change at the next appropriate opportunity.

Description of Options Considered

17.4 **Option 0: Do nothing.** Without legislation, the Government would reaffirm its commitment to follow, but not legislate for, the proposed terms when appointing the Chief Executive of the FCA, as it did in the appointment of the incoming candidate.

17.5 **Option 1: (Preferred option) Using the Financial Services Bill to amend Schedule 1ZA of the Financial Services and Markets Act** to insert provisions which will deliver

[76] Bank of England and Financial Services Bill, Report Stage, Hansard, 19 April 2016, Volume 608, Column 805 https://hansard.parliament.uk/Commons/2016-04-19/debates/16041934000001/BankOfEnglandAndFinancialServicesBill(Lords)

[76] Bank of England and Financial Services Bill, Report Stage, Hansard, 19 April 2016, Volume 608, Column 805 https://hansard.parliament.uk/Commons/2016-04-19/debates/16041934000001/BankOfEnglandAndFinancialServicesBill(Lords)

the previous commitment to make the FCA Chief Executive subject to a fixed, once renewable 5-year term.

Policy Benefits

17.6 This measure will increase transparency and accountability of this high-profile Government appointment and make it consistent with comparable appointments.

Policy Costs

17.7 As this measure is public-sector facing, there will are no EANDCB costs associated with this measure.

Summary

17.8 The Government will fulfil a commitment to change the legislation governing the appointment of the FCA CEO to make it subject to a fixed 5-year term renewable once, which ensures consistency with equivalent provisions for other high-profile appointments and ensures transparency and accountability.

ANNEX A: List of K-factors

Risk-type	K-factor	Metric	Rationale
Risk to Customer (RtC)	K-AUM	Assets under management	The risk of harm to clients from incorrect discretionary management of customer portfolios or poor execution, providing customer reassurance in terms of the continuity of service of ongoing portfolio management and advice
	K-CMH	Client money held	The risk of harm where an investment firm holds the money of its customers, regardless of whether they are on its own balance sheet or segregated in other accounts.
	K-ASA	Assets safeguarded and administered	The risk of safeguarding and administering customer assets, and ensures that investment firms hold capital in proportion to such balances, regardless of whether they are on its own balance sheet or segregated in other accounts.
	K-COH	Customer orders handled	The risk to clients of a firm which executes their orders in the name of the client, and not in the name of the firm itself, e.g. as part of 'execution-only' services and in the reception and transmission of orders.
Risk to Market (RtM)	K-NPR	Net position risk	The risk of trading exposures in financial

			instruments, FX and commodities based on the CRR
	K-CMG	Clearing member guarantee	The margin posted with a clearing member against trading risks
Risk to Firm (RtF)	K-TCD	Trading counterparty default	The risk to an investment firm of counterparties failing to fulfil their obligations, multiplying exposures by risk factors based on the CRR, into account the mitigating effects of effective netting and the exchange of collateral.
	K-CON	Concentration risk	Concentration risk in relation to individual or highly connected private sector counterparties with whom firms have exposures above 25% of their capital and resulting in capital add-ons in line with the CRR.
	K-DTF	Daily trading flow	The operational risks in large volumes of intra-day trades based on the gross value of settled cash trades and notional value of derivatives.

Source: European Commission Staff Working Document[77]

Annex B: formula for calculating capital requirements under the K-factor approach

*Capital requirement = (a*K-AUM + b*K-CMH + c*K-ASA + d*K-COH + (K-NPR or K-CMG where permitted) + K-TCD + K-CON + e*K-DTF*

Where a, b, c, d and e are coefficients. The amount of a K-factor can be zero if a firm does not undertake the relevant activity.

[77] See European Commission Staff Working Document SWD(2017)481: [Review of the prudential framework for iinvestment firms]

Annex C: coefficients for each new K-factor (beside K-CMG)

K-factor	Coefficient
K-AUM	0.02%
K-ASA	0.04%
K-CMH	0.4% (segregated accounts)/0.5% (non-segregated accounts)
K-COH & K-DTF	0.1/0.01%

Source: European Commission Staff Working Document[78]

Annex D: change in capital requirements for a given method of calculation

Proposed IFR capital requirements					
IFR requirement applicable	Firms		Capital required		
	Number	%	Mean(1)	Total	
FOR	1,646	52%	£2.5m	£4,139m	58%
PMR	1,335	42%	n/a(1)	£120m	2%
K-factor	213	7%	£13.5m	£2,883m	40%
	3,194	100%	£2.2m	£7,142m	100%

Current capital requirements(2)					
IFR requirement applicable	Firms		Capital required		
	Number	%	Mean(1)	Total	
FOR	1,646	52%	£2.5m	£4,170m	55%
PMR	1,335	42%	n/a(1)	£121m	2%
K-factor	213	7%	£15.2m	£3,246m	43%
	3,194	100%	£2.4m	£7,537m	100%

Change in capital requirements							
IFR requirement applicable	Firms		Capital required				
	Number	%	Mean(1)		Decrease	Increase	Total Net
FOR	1,646	52%	(£19k)	(1%)	(£456m)	£425m	(£31m)
PMR	1,335	42%	n/a(1)	n/a(1)	(£10m)	£9m	(£1m)
K-factor	213	7%	(£1,704k)	(11%)	(£871m)	£508m	(£363m)
	3,194	100%	(£124k)	(5%)	(£1,337m)	£942m	(£395m)

Source: FCA

(1) FOR and K-factors are continuous distributions. The mean has been included but not the mode and median. PMR, which constitutes only 2% of the total capital in the system is a discrete distribution with 3 possible outcomes of €50k, €125k and €730k so a mean does not exist.

(2) To assess the impact of the IFR, firms are categorised in accordance with the IFR requirement that will be applicable. This will differ to the requirement firms are currently subject to. For example, firms that will calculate prudential requirements based on K-factors will not be doing so currently as these are being implemented for the first time by the IFR.

[78] See European Commission Staff Working Document SWD(2017)481: *Review of the prudential framework for investment firms*