**Title:** Financial Services and Markets Bill

**IA No:**

**RPC Reference No:**

**Lead department or agency:** HM Treasury

**Other departments or agencies:** N/A

IMPACT ASSESSMENT (IA)

**Date:** 05/12/2022

**Stage:** Primary Stage IA

**Source of intervention:** Domestic

**Type of measure:** Primary Legislation

**Contact for enquiries:** 2022FSBillTeam@hmtreasury.gov.uk

## Summary: Intervention and Options

**RPC OPINION:** GREEN

| **Cost of Preferred (or more likely) Option** (in 2019 prices) | | | |
|---|---|---|---|
| **Total Net Present Social** | **Business Net Present Value** | **Net cost to business per year** | **Business Impact Target Status** |
| -3.4 | -3.4 | 0.4 | In Scope |

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

The UK's financial services sector is the engine of the UK economy. Having left the EU, it is important that the government builds on the UK's historic strengths and renews the UK's position as the world's pre-eminent financial centre. Legislation will support the delivery of the government's ambitious vision for an open, sustainable, and technologically advanced financial services sector; that acts in the interests of communities and citizens, creating jobs, supporting businesses, and powering growth across all of the UK.

**What are the policy objectives of the action or intervention and the intended effects?**

The Bill seizes the opportunities of EU exit, tailoring financial services regulation to UK markets to bolster the competitiveness of the UK as a global financial centre and deliver better outcomes for consumers and businesses. The Bill has five key objectives:

- Implementing the outcomes of the Future Regulatory Framework (FRF) Review, with new objectives for the regulators to facilitate growth and competitiveness and repealing retained EU law to enable reforms to key areas of financial services regulation, including Solvency II and MiFID.
- Making the UK an open and global financial hub, to facilitate greater cross-border activity in financial services.
- Harnessing the opportunities of innovative technologies and enabling their safe adoption.
- Bolstering the competitiveness of UK markets and promoting the effective use of capital, via the implementation of the outcomes of the Wholesale Markets Review.
- Promoting financial inclusion and enhancing consumer protection, by protecting people's access to cash and ensuring that victims of 'authorised push payment' scams are reimbursed.

**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. In each case, the impacts have been assessed against a 'do nothing' baseline and alternative policy options, including non-regulatory options 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 measures in this Bill are amendments to existing regulatory regimes to make them more proportionate or effective.

**Will the policy be reviewed?** It will be reviewed. **If applicable, set review date:** **N/A**

| Is this measure likely to impact on international trade and investment? | | Yes | | |
|---|---|---|---|---|
| Are any of these organisations in scope? | **Micro** Yes | **Small** Yes | **Medium** Yes | **Large** Yes |
| 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: Date: 5th December 2022

## Summary: Analysis & Evidence Policy Option 1

**Description: Implementing the Financial Services and Markets Bill**

**FULL ECONOMIC ASSESSMENT**

| Price Base Year 2019 | PV Base Year 2023 | Time Period Years: 10 | Net Benefit (Present Value (PV)) (£m) |
|---|---|---|---|
| | **Low:** -2.6 | **High:** -4.2 | **Best Estimate:** -3.4 |

| COSTS (£m) | Total Transition (Constant Price) | | Average Annual (excl. Transition) | Total Cost (Present Value) |
|---|---|---|---|---|
| **Low** | 2.6 | 10 | 0 | 2.6 |
| **High** | 4.1 | 10 | 0 | 4.1 |
| **Best Estimate** | 3.4 | 10 | 0 | 3.4 |

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

There are three measures for which it is possible to provide an EANDCB at this stage: the Wholesale Markets Review, amendments to credit union legislation and changes to the arrangements for insurers in financial difficulties. For these measures, the familiarisation costs have been estimated.

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

The other measures in the Bill will enable changes which require further action from the government (in the form of secondary legislation) or the financial services regulators – the Financial Conduct Authority (FCA), the Prudential Regulation Authority (PRA) or the Bank of England, in the form of regulatory rules, which may ultimately result in costs for businesses. There are non-monetised costs which may arise from primary legislation and through future secondary legislation or regulatory rules. These may include potential familiarisation costs, compliance costs, requirements to change systems and staffing costs. This Impact Assessment sets out the government's 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 | Total Benefit (Present Value) |
|---|---|---|---|---|
| **Low** | N/A | N/A | N/A | N/A |
| **High** | N/A | N/A | N/A | N/A |
| **Best Estimate** | N/A | N/A | N/A | N/A |

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

The benefits of this Bill cannot be fully quantified and monetised at this stage since they rely on subsequent decisions or future action including secondary legislation. For regulatory changes which are deemed permissive in nature, calculating monetised benefits was not considered possible due to uncertainty about how many firms would take up these options (which they would only do if they expected that to deliver a net benefit to the firm).

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

The Bill is designed to enable a series of changes that are expected to ultimately result in a number of benefits to businesses. Non-monetised benefits include but are not limited to increasing the resilience of the Financial Services sector, reducing administrative or transactional costs where relevant, improving outcomes for consumers and businesses, increased transparency and innovation, and creating a financial services regulatory framework that better works for the UK economy. As above, further detail will be set out in Impact Assessments for subsequent secondary legislation and/or in the cost-benefit analysis undertaken by the relevant regulator.

| Key assumptions/sensitivities/risks | **Discount** | 3.5% |
|---|---|---|

The estimates and assessments represent an initial illustrative indication of the impacts of the Financial Services and Markets Bill. 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:** 0.4 | **Benefits:** 0.0 | **Net:** 0.4 | 2 |

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# Financial Services and Markets Bill: Introduction

1.1 The financial services (FS) sector plays a crucial role in the UK economy, creating jobs across the UK, supporting SMEs, contributing taxes, driving regional growth and investment, tackling climate change and enhancing the adoption of technology and innovation. Financial and related professional services[1] employ more than 2.3 million people across the UK, with two thirds of them based outside London. The sector also contributes more than £193 billion to the UK economy and provided £75.6 billion in tax in 2019/20 - helping to fund vital public services.

1.2 The government's vision for the UK financial services sector is for an open, green, and technologically advanced sector that is globally competitive and acts in the interests of communities and citizens, creating jobs, supporting businesses, and powering growth across all of the UK. The Financial Services and Markets Bill is central to delivering this vision. The Bill seizes the opportunities of EU Exit, tailoring financial services regulation to UK markets to bolster the competitiveness of the UK as a global financial centre and deliver better outcomes for consumers. It contains over 20 measures which will deliver the government's vision for the sector by advancing five main objectives:

1. Implementing the outcomes of the Future Regulatory Framework (FRF) Review, and putting in place a comprehensive domestic model of financial services regulation:

1.3 The Bill will repeal retained EU law on financial services so that it can be replaced with an approach to regulation that is designed for the UK with firm-facing rules generally set by the regulators. It gives HM Treasury powers to restate parts of retained EU law that should be maintained in domestic legislation, and to set "have regards" and obligations on the regulators, taking a similar approach to the prudential measures in FS Act 2021.

1.4 The Bill will introduce new secondary statutory objectives for the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) to provide for a greater focus on growth and international competitiveness, whilst maintaining their existing primary objectives. The Bill will also replace the FCA and PRA's sustainable growth principle with a requirement to have regard to the government's climate change target to achieve a net zero economy by 2050. The Payment Systems Regulator's (PSR's) sustainable growth principle will also be amended to require it to have regard to the climate change target.

1.5 The Bill introduces broad rule-making powers for the Bank of England (Bank) over central counterparties (CCPs) and central securities depositories (CSDs), so that it can set detailed rules for these firms, alongside an updated framework of statutory objectives and principles. This includes a sustainable growth principle incorporating the government's commitment to achieving a net zero economy by 2050.

1.6 Measures will also ensure appropriate oversight of the regulators by Parliament and government and strengthen the regulators' engagement with industry stakeholders,

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[1] https://www.gov.uk/government/publications/better-regulation-framework

such as a power for HM Treasury to direct the regulators to review their rules and the establishment of a new Cost Benefit Analysis (CBA) panel to consider the regulators' CBAs before publication of a consultation.

2. Making the UK an open and global financial hub:

1.7 The Bill will enable the implementation of mutual recognition agreements (MRAs), including the UK's ongoing negotiations for a UK-Switzerland MRA. It will give HM Treasury powers to amend legislation in order to give effect to financial services MRAs.

1.8 The Bill also makes changes to the UK's securitisation standards to improve choice for UK investors by introducing a new equivalence regime for overseas securitisations that are Simple, Transparent, and Standardised (STS).

3. Harnessing the opportunities of innovative technologies in financial services:

1.9 The Bill will bring stablecoins (a type of cryptoasset) within regulation when used as a form of payment, paving the way for safe adoption in the UK, by giving HM Treasury the power to bring them into the scope of e-money and payments regulations.

1.10 The Bill will allow the government to establish regulatory 'sandboxes' for financial market infrastructure (FMI), to allow firms to experiment with new technologies and practices, such as distributed ledger.

1.11 The Bill will also introduce a measure that will allow the financial regulators to oversee the services critical third parties provide to the finance sector. This will enable industry to benefit from new technologies, whilst supporting the resilience of the finance sector.

4. Bolstering the competitiveness of UK markets and promoting the effective use of capital:

1.12 As noted previously, the Bill repeals retained EU law and provides HM Treasury with the necessary powers to deliver reforms including the outcomes of Lord Hill's UK Listing Review, which will make the UK's prospectus regime simpler, more agile and more effective.

1.13 The Bill also directly implements a number of the key outcomes of the Wholesale Markets Review. This includes removing unnecessary restrictions on where and how trading can happen so that firms have greater choice about where they can trade whilst maintaining high standards of regulation. Other elements of the Wholesale Market Review will be delivered to a longer timeline using the FRF Review powers in the Bill.

1.14 It will also give regulators greater powers to manage insurers and central counterparties (CCPs) in financial distress, ensuring the UK meets global standards agreed at the FSB, and introduce a new senior managers and certification regime to strengthen the individual accountability of senior managers and promote high standards of conduct within FMIs.

5. Supporting the levelling up agenda, promoting financial inclusion and consumer protection:

1.15 The Bill will protect access to cash by giving the FCA responsibility and powers to ensure that people can continue to access cash withdrawal and deposit facilities. Treasury will be responsible for designating banks, building societies, and cash coordination arrangements for FCA oversight.

1.16 It will also expand the list of products and services that credit unions are permitted to offer.

1.17 The Bill will strengthen the rules around financial promotions and put a duty on the Payment Systems Regulator to mandate the reimbursement of victims of 'authorised push payment' scams.

1.18 The Bill also puts the current, voluntary Wider Implications Framework on a statutory footing. This will ensure that the FCA, FOS and FSCS continue to cooperate with each other on issues which appear to have significant implications for the other organisations, or for the wider financial services market. This will promote continued effective cooperation on wider implications issues.

1.19 As a global financial centre, certain changes are required to maintain the effectiveness of the UK's financial services regulatory framework and to ensure that it remains at the forefront of international standards. The Bill, therefore, contains a number of technical measures that will ensure that this is the case.

Summary of methodology and limitations

1.20 A monetised impact has been given for three measures (Wholesale Markets Review, credit unions and arrangements for insurers in financial difficulties). The estimated equivalent annual net direct cost to business (EANDCB) has been provided in relation to these costs. For these measures the familiarisation costs have been monetised and an EANDCB provided.

1.21 The methodology for calculating familiarisation costs is based on that used for the Impact Assessment for the Financial Services Act 2021[2]and considers the estimated time taken for an appropriate qualified person to read the relevant legislation. The analysis considers whether this is likely to be undertaken by an employee of the affected business, or whether the business is likely to contract external advice (e.g. by procuring legal advice from a specialist law firm). HM Treasury acknowledges that affected businesses may face other costs associated with familiarisation (such as dissemination to relevant employees) and this is discussed qualitatively in the assessment, but it has not been possible to provide cost estimates for these broader familiarisation changes in all instances.

1.22 Although HM Treasury has attempted to capture the full impact of the intended legislative approach in this impact assessment, it has not been possible to quantify

[2] https://www.gov.uk/government/publications/better-regulation-framework

some impacts at this stage due either to uncertainty in the direction of future policy or insufficient data.

1.23 In most 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, in the form of regulatory rules. Details of implementation plans have been outlined where relevant.

1.24 For the purposes of this impact assessment, HM Treasury has sought to provide an indicative qualitative assessment of the likely impacts of the whole policy across both primary legislation and all secondary legislation necessary for the bill to come into force. Owing to a range of factors that may affect the analysis, the analysis in this Impact Assessment should not be interpreted as a forecast of what HM Treasury thinks will happen, but rather an exploration of what could happen as a result of the changes made by, and enabled by, this legislation.

1.25 Where it has not been possible, to provide such an indicative assessment, the approach in this IA has been to explain the rationale for taking action, outline the other options considered, and to set out the anticipated costs and benefits based on the government'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.[3]

1.26 As the necessary policy positions are settled and it becomes possible to better understand potential impacts, HM Treasury will make efforts to ensure that, where possible, such impacts are appropriately quantified when the relevant future legislation is introduced.

1.27 At the point of secondary legislation, and in line with the government's approach to better regulation under the Better Regulation Framework, HM Treasury will make efforts to further consult on and increase its understanding of the potential further impacts of the relevant measures in the Bill, including through appropriate stakeholder engagement. More detailed qualitative and quantitative cost-benefit analyses are expected to be covered in the IAs accompanying the relevant secondary legislation enabled by the Bill. HM Treasury will also make efforts to engage with c), prior to the submission of IAs produced to accompany future secondary legislation where appropriate.

1.28 Similarly, the financial services regulators are subject to statutory requirements in FSMA which, in general, require them to consult with the public on proposed rule changes, and include a Cost-Benefit Analysis. More information on this, in particular within the context of considering the impacts on Small and MicroBusinesses (SMBs), is provided below.

[3] https://www.gov.uk/government/publications/better-regulation-framework

Approach to costs for regulators

1.29 Several measures in the Bill will have resource implications for the financial services regulators. As these are public bodies, these impacts do not contribute to the EANDCB. However, this Impact Assessment provides some detail of the possible impacts where this has the potential to be significant and it is possible to do so. HM Treasury works closely with the financial services regulators, and they have been closely involved in the policy making process. Therefore, it is assumed that there are no familiarisation costs for the public sector as all public sector bodies will already understand the legislation.

1.30 The PRA, FCA and Payment Systems Regulator (PSR) are independent bodies from government and raise funding for their operations through an annual levy on authorised firms which they must consult on annually consultations. The Bank does not receive a budget from government but funds its own activities in a number of ways, including through the income it generates from providing various functions to the financial services sector.

1.31 Where this Bill puts a new requirement on the regulator, there may be an increased cost for the regulator associated with this. However, the proposals will provide the regulators with the flexibility to make rules in the most appropriate way. The regulators are also required to consider the efficiency of their use of resources as part of the existing regulatory principles. The regulators have broad discretion to determine how best to exercise their functions and undertake annual business planning that sets out their role and priorities, and how they intend to deliver them. They may consider, for example, reprioritisation and changing how they approach other parts of their role, to take on any additional responsibilities they will acquire as a result of this Bill or subsequent secondary legislation. Therefore, it is not possible to say whether there will be increased costs to the regulators because of the Bill, or to quantify them with any level of certainty.

*Approach to costs of regulator levies*

1.32 Some measures in this Bill, including the repeal of retained EU law and the Designated Activities Regime will place more responsibility on the financial services regulators including increased rulemaking and enforcement responsibilities. The government expects this will result in increased running costs for the financial services regulators over time. The regulators recover their running costs via fees and levies from the firms they regulate.

1.33 Each year, the PRA and FCA publish and consult on their proposed approach to fees and levies, including rates. When consulting on new rules, FSMA requires the PRA and the FCA to include an explanation of why it believes making the proposed rules is compatible with its general duty under FSMA to have regard to the regulatory principles in s.3B of FSMA4 which requires the FCA and the PRA to have regard to 'the principle that a burden or restriction which is imposed on a person, or on the

[4] Section 138I, section 138J Financial Services and Markets Act 2000

carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction.5 The government therefore expects that any increases to FCA and PRA fees and levies as a result of the measures in this Bill should not place a disproportionate burden on firms.[6,7]

Approach to small and microbusiness assessment

1.34 When making regulatory requirements, the UK's financial services regulators - the PRA and the FCA - are required by FSMA 20008 to have regard to 'the principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction'. This is intended to ensure that regulatory requirements made by the regulators, including those made as a result of the measures in this Bill, should remove and not impose unnecessary regulatory burdens on small and microbusinesses. The same regulatory principle is extended to the Payment Systems Regulator (PSR) under its founding legislation, the Financial Services (Banking Reform) Act 2013 (FSBRA). For this reason, the government expects such measures to benefit these firms.

1.35 The government is content that when fulfilling their increased responsibilities under this Bill the regulators will follow appropriate processes to ensure the corresponding impact on Small and Micro Businesses (SMBs) is considered, and if possible and appropriate mitigated. More information on these processes is included below.

*PRA's approach to considering the impact of regulation on SMBs*

1.36 As part of its approach to cost benefit analysis (CBA), the PRA assesses the impact of new rules and policies on firms, including SMBs, taking account of proportionality where appropriate. Furthermore, in line with its obligations under the new accountability and stakeholder engagement measures in this Bill, the PRA will be required to publish its CBA framework for consultation. This will lead to the introduction of more effective mechanisms for stakeholder engagement on regulator rules, ensuring all firms including SMBs will be better able to engage in and influence the development of regulator rules. This will allow for those rules to better take account of and address the specific challenges and opportunities faced by a variety of firms. More information on this measure can be found in the FRF Review: Accountability and Stakeholder Engagement section of this Impact Assessment.

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[5] Section 3B, Financial Services and Markets Act 2000, https://www.legislation.gov.uk/ukpga/2000/8/section/3B/2018-01-03

[6] Compatibility statement, Regulatory fees and levies: policy proposals for 2022/23, Financial Conduct Authority, November 2021, https://www.fca.org.uk/publication/consultation/cp21-33.pdf

[7] PRA statutory obligations, Consultation Paper, Regulated fees and levies: Rates proposals 2022/23, Prudential Regulation Authority, April 2022, https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2022/april/regulated-fees-and-levies-rates-proposals-2022-23.pdf?la=en&hash=6926E36A60D6DFC54EE97775897C32210FC32DCF

[8] Section 3B, Financial Services and Markets Act 2000, https://www.legislation.gov.uk/ukpga/2000/8/section/3B/2018-01-03

1.37 There is prior evidence of the PRA's commitment to considering and improving the impact of its rules on SMBs. In 2020, the PRA reduced complexity and increased flexibility in the capital regime for Credit Unions, including by removing barriers to growth for smaller firms.

1.38 The PRA is also working on creating a simpler but resilient prudential framework for smaller, non-systemic banks and building societies (a 'Strong and Simple' framework). The PRA considers that this framework will help to support competitive and dynamic markets in the sectors that it regulates. The work started with the publication of a discussion paper in 2021 that among other things explained how such a framework could help the PRA advance its objectives. In April 2022, the PRA conducted an initial consultation of the framework and plans to consult further due course. More information on the 'Strong and Simple' framework can be found in the Future Regulatory Framework Review section under FRF Review Case Studies - "Strong and Simple" prudential framework.

*The FCA's approach to considering the impact of regulation on SMBs*

1.39 The FCA also uses cost-benefit analysis (CBA) to analyse and estimate the impact of its regulatory interventions. This helps the FCA use its rule-making powers appropriately and proportionately, and to consider the impacts on the range of firms it regulates and on stakeholders who may benefit from its interventions. The FCA have a published framework, setting out how it conducts CBAs, and have stated their commitment to the continuous improvement of the analysis of the costs and benefits of its interventions.

1.40 The FCA has also committed to consulting publicly when it updates its CBA framework in response to the measures relating to the CBA framework in this Bill, which it intends to do following Royal Assent. The FCA use CBAs to inform decisions both in terms of (i) whether the proposed policy intervention is proportionate and, prior to that, (ii) whether the proposed intervention is the best option for the market, firms and consumers involved. As well as seeking information and data from firms in developing its CBAs and policy proposals, the FCA consult on its CBAs when its consults on the policy intervention. This is to ensure that stakeholders, including different types and sizes of businesses, including SMBs have the opportunity to challenge FCA analysis and provide further information and data if necessary. More information on how the measures in this Bill will improve the regulators' approach to CBA can be found in FRF Review: Accountability and Stakeholder Engagement section of this impact assessment.

1.41 The FCA takes into account, as far as reasonably practicable and proportionate, the different impacts for different sizes and types of firms, and so consider the proportionality of its interventions for different sizes and types of business. A recent example of where the FCA have considered the proportionality of its proposals carefully in relation to the size of firm affected is the implementation of the Investment Firms Prudential Regime (IFPR).The FCA considered how both small and medium firms would be impacted by changes to the prudential regime including an assessment of implementation, IT and training costs.

1.42 In addition, the FCA often seek views from its stakeholder panels. This includes the Smaller Business Practitioner Panel (SBPP) which represents the interests of practitioners of firms of small or medium size within their sector across the range of regulated activities as regulated by the FCA. The FCA has a statutory duty to establish and consult the SBPP on the extent to which its policies and practices are consistent with its general duties. This includes on its significant CBAs both before and during public consultation. The FCA will also be consulting the new CBA Panel once established.

1.43 Identification of any indirect impacts of the FCA’s proposed interventions is a key part of its CBA process. The FCA's published framework sets out in more detail its approach to analysing and estimating indirect impacts.

*The PSR’s approach to considering the impact of regulation on SMBs*

1.44 The PSR operates as a subsidiary of the FCA, based on legislation and a broad regulatory approach that is partially modelled on FSMA. Like the FCA, it also uses cost-benefit analysis (CBA) to analyse and estimate the impact of its regulatory interventions. Unlike the FCA and PRA, it does not maintain a rulebook but acts by power of direction, including the ability to impose regulatory requirements of general application. As a general rule, before the PSR may impose any such generally-applicable requirements, it is obliged to consult the other regulatory authorities, and publish a draft proposed requirement accompanied by its cost-benefit analysis. This helps the PSR exercise its powers appropriately and proportionately, and consider the impacts on the range of firms it regulates and on stakeholders who may benefit from its interventions.

1.45 In addition to the proportionality principle described above, the PSR must have regard to a number of binding statutory regulatory principles – including the desirability of the PSR supporting sustainable UK economic growth; and exercising its powers in a way that recognises differences between different types of market actors. The PSR also takes into account the impact of its measures across a range of stakeholders, including small and micro businesses. It includes these groups in relevant stakeholder reach-out exercises when proposed regulatory requirements are likely to impact them, and routinely considers the impact on smaller actors specifically within its cost-benefit analyses.

## Future Regulatory Framework Review

2.1 A key part of the government's vision for financial services is the commitment to maintain and build on the UK's internationally-respected approach to financial services regulation. The government intends to tailor its approach to reflect the UK's position outside the EU, while ensuring it supports and promotes the interests of UK markets and maintains high regulatory standards in the face of new and evolving risks. The FRF Review is a key pillar of delivering this vision, as it considers the UK's overall approach to financial services regulation. It also complements a number of further reviews and initiatives that are underway on specific areas of financial services regulation intended to support and encourage growth in the UK as a global financial services hub, while maintaining high regulatory standards, as it provides a mechanism for updating the current regulatory requirements in these areas.

2.2 The FRF Review was established to determine how the financial services regulatory framework should adapt to the UK's position outside of the EU. In particular, the FRF Review provides an important opportunity to ensure that the UK maintains a coherent, agile, and internationally-respected approach to financial services regulation that delivers appropriate protections and promotes financial stability.

2.3 The UK model of financial services regulation was introduced by Financial Services and Markets Act 2000 (FSMA). The FSMA model delegates the setting of regulatory requirements to expert, operationally-independent regulators, the PRA and the FCA, that work within an overall policy framework set by government and Parliament.

2.4 The FSMA model has been adapted over the years, and the government believes that it remains the most appropriate way to regulate financial services in the UK. It ensures that the regulators' real-world, day-to-day experience of supervising financial services firms is central to the regulatory policymaking process. It also provides flexibility for the regulators to update standards efficiently in response to changing market conditions and emerging risks.

2.5 The FRF Review has considered how to enhance the FSMA model to ensure that the framework is fit for the future.

2.6 The government has engaged extensively with stakeholders on the FRF Review, including through a call for evidence and two consultations since July 2019. The first consultation, published in October 2020, set out an overall approach to financial services regulation, focusing on the split of responsibilities between Parliament, the government and the financial services regulators, and seeking to build on the strengths of the FSMA model. Respondents to the government's first consultation on the FRF Review overwhelmingly supported the government's proposal to establish a comprehensive model of regulation based on FSMA. Consultation respondents agreed with the government's view that the FSMA model is world-leading and that no alternative model provided a preferable approach to financial services regulation.

2.7 The second consultation, published in November 2021, set out detailed proposals for reform. Respondents were supportive of the proposals in this consultation. Each consultation received over 100 responses and were accompanied by extensive stakeholder engagement.

2.8 The FSMA model splits responsibilities across Parliament, HM Treasury, and the regulators as follows:

a. Parliament, through primary legislation, sets the overall approach and institutional architecture for financial services regulation, including the regulators' objectives.

b. Parliament establishes the parameters within which HM Treasury sets the 'regulatory perimeter' through secondary legislation, specifying which financial activities should be regulated and the circumstances in which regulation should apply.

c. The expert and operationally-independent regulators have the statutory responsibility for setting the direct regulatory provisions that apply to firms which carry out regulated activities, using the powers given to them by FSMA, and following the processes established by FSMA.

2.9 FSMA empowers the PRA and the FCA to make rules which apply to anyone carrying out regulated activities. The regulators are required to maintain arrangements for supervising authorised persons, and FSMA gives them powers to monitor and enforce compliance with the rules. Both the PRA and the FCA publish their approach to supervision and enforcement.

2.10 In the years since FSMA was introduced, and in particular following the global financial crisis, EU financial services regulation expanded into new areas and became significantly more detailed, which has affected the operation of the FSMA model. The development of a single market in the EU for financial services, as well as interventions to address regulatory failures of the global financial crisis, resulted in EU legislation covering many key areas of financial services regulation in significant detail. This complicated the split of responsibilities established by FSMA, constraining the regulators' ability to determine the most appropriate regulatory requirements for UK markets, as they were required to apply EU requirements and operate within the EU framework.

2.11 Now that the UK is outside the EU, this is the first time that it has been possible to consider how the UK's domestic framework for financial services regulation should adapt to ensure that it is fit for the future.

2.12 This includes the opportunity to better align regulatory requirements which are currently across domestic primary and secondary legislation, retained EU law, and regulator rulebooks. Respondents to the first FRF Review consultation noted the inconsistent approach for regulation of domestic origin and regulation of EU origin, agreeing that the Review provided an opportunity to address the fragmented nature of the rulebook.

2.13 While retained EU law has been incorporated into the current framework, it has complicated the current FSMA model, as many of the direct regulatory provisions which apply to firms are now set out in retained EU law, rather than in the rulebooks of the regulators. Much of this retained EU law can only be amended through primary legislation, meaning that it is not possible in many areas to regulate in an

agile and flexible way that reflects changing markets, as the FSMA model was designed to do.

2.14 Financial services regulation needs to be kept under regular review, to ensure that it is achieving its objectives, to address new and emerging risks, and to take account of technological developments.

2.15 If the government does not take action, there are many areas of financial services regulation that cannot be updated without taking forward primary legislation. This could lead to delays in responding to new risks. It would also prevent the regulators from taking the lead on determining the appropriate regulatory requirements.

2.16 A well-functioning and coherent financial services regulatory framework is also essential to the UK's position as a global financial centre and can act as an asset for attracting and maintaining international business.

2.17 The consultations that the government has undertaken in this area have demonstrated broad agreement that these issues need to be addressed.

2.18 Additionally, the Payment Systems Regulator (PSR), the economic regulator responsible for overseeing payments systems, was initially out of scope of the FRF Review, pending a specific government consultation on the payments 'perimeter' which was published in July 2022. However, in light of stakeholder feedback, and recognising that the PSR will assume responsibility for some areas of retained EU law, HM Treasury has considered that it would be more consistent to apply the FRF Review accountability mechanisms to the PSR through this Bill.

2.19 The Bill delivers the following measures, implementing the outcomes of the FRF Review:

a. Repeal of retained EU law: Repealing retained EU law relating to financial services, so that the regulators are able to make the direct regulatory requirements which apply to firms in their rulebooks and in accordance with the domestic FSMA framework;

b. Designated Activities Regime: The creation of a Designated Activities Regime in FSMA, so that the activities related to financial markets, including where rules are currently set directly in retained EU law, can be regulated in a manner which reflects the level of risk these activities pose;

c. Objectives and principles: Changes to the objectives and principles of the PRA and the FCA, to introduce new secondary objectives on growth and international competitiveness. Amendments to the regulatory principles for the PRA, the FCA, the Bank of England (Bank) and the PSR to incorporate the government's net zero target;

d. Accountability and stakeholder engagement: Measures to increase the accountability of the PRA, the FCA and the PSR to Parliament, strengthen their relationship to HM Treasury, and enhance their engagement with stakeholders; and

e. Regulation of FMI by the Bank: Measures to ensure that the Bank is able to make rules for certain Financial Market Infrastructure when retained EU law is repealed, within a wider framework established by the Bill.

f. FCA Financial Market Infrastructure: a general rulemaking power for the FCA to make rules for certain Financial Market Infrastructure when retained EU law is repealed, within the FCA's existing FSMA framework.

2.20 These are considered in turn in the following sections.

Policy objectives and expected benefits:

2.21 The FRF Review measures in the Bill deliver changes to the overall framework for financial services regulation, that taken together are intended to ensure that the UK maintains a coherent, agile and internationally-respected approach to regulation that delivers appropriate protections and promotes financial stability.

2.22 Overall, the government expects the measures, in combination, to have the following outcomes:

a. A coherent approach to financial services regulation based on the FSMA model. The FRF Review has concluded that the FSMA model – where the regulators generally set the detailed requirements which apply to firms, within a framework set by Parliament and government – is the best model of regulation for the UK. Therefore, the Bill applies this model across financial services regulation, including areas covered by retained EU law that are not currently within the FSMA model.

b. Rules designed for the UK. EU rules are designed to work for all member states, and to support the Single Market. By repealing retained EU law, the regulators will be able to make the rules which best suit UK firms and markets specifically.

c. An agile and tailored regulatory regime. By moving to a comprehensive FSMA model, where regulatory requirements on firms are set directly in regulator rulebooks, the regulators will be able to respond quickly to changing markets and alter their requirements accordingly without the need for legislation, while allowing for appropriate consultation on changes.

d. An increased focused on growth and international competitiveness. The government expects that new growth and competitiveness objectives for the regulators will result in more proportionate rulemaking, while maintaining high regulatory standards. This will ensure the regulators are supporting the government's vision for a sector that is globally competitive and acts in the interests of communities and citizens.

e. Transparency on how rules are supporting public policy priorities. The measures relating to engagement with HM Treasury will increase transparency regarding how the regulators can support public policy priorities within the remits given to the government by Parliament.

f. A clearer basis for effective accountability and scrutiny. The changes are designed to support more effective accountability, scrutiny and engagement of the regulators by Parliament and HM Treasury. This will ensure greater transparency at each stage of the regulatory process and appropriate democratic oversight of the regulatory framework.

g. Improved stakeholder engagement leading to better rulemaking. The measures will lead to increased transparency regarding how regulated firms can engage with and provide input into the rulemaking process. The requirements to maintain a statement of policy on their conduct of cost-benefit analysis (CBA) and for the PRA and the FCA to each establish and maintain a CBA panel is expected to improve the quality of CBA being produced by the regulators, which will support overall improvements to regulatory policymaking.

Summary of expected costs

2.23 The Bill puts in place a comprehensive framework for reform. Subsequent actions by HM Treasury and the regulators, in the form of secondary legislation and rules, will ultimately result in costs to business. These will be subject to impact assessments in the usual way.

2.24 However, the government expects that there may be some transitional costs required to operationalise these measures. These may include familiarisation costs for firms which are currently required to follow rules set out in retained EU law which will repealed by this Bill.

2.25 There may also be costs associated with engaging with the regulators' rulemaking process. When the regulators make rules, they are required by FSMA to consult publicly on proposed rule changes. It is likely that a subset of those who will be affected will wish to engage with this consultation process, for example by preparing consultation responses, which could result in costs.

2.26 The Bill will provide additional rulemaking responsibilities for the regulators in areas where they are not currently able to make rules, and will enhance their existing accountability requirements. The regulators will need to consider how to resource these new responsibilities, in the usual way. The regulators may reprioritise their resources so that these new responsibilities could be delivered within their existing budgets, or they may decide to increase the available resources by increasing the levies on industry by which they are funded.

2.27 Their decisions in this regard are likely to have some impact on industry. If they increase their levy, this would represent a direct cost to industry. Decisions to reprioritise resources could result in indirect costs or benefits to industry – for example, by delaying other reforms which could reduce regulatory costs or provide opportunities for new business.

2.28 Each year, the PRA, FCA and PSR publish their business plans, setting out their priorities for the year, and also consult on how they propose to recover the costs of this work through their levy. For the PSR, the FCA is responsible for approving their annual plan, and collecting the levy from supervised entities on their behalf.

A note on methodology

2.29 This legislation which implements the FRF Review is enabling or framework legislation. This means that it has generally not been possible to produce a quantitative assessment of the impact of these measures.

2.30 The measures will impact almost everything that the regulators do, but it will only be possible to fully understand and quantify that impact, once the regulators come to make rules in specific areas of regulation and carry out their policymaking process in line with the new arrangements.

2.31 It is not possible to quantify the effect of these enhancements to FSMA as it would require HM Treasury to make judgements on how each regulator will embed and operationalise the changes. The government expects to see improvements to the FSMA model of regulation, rather than to achieve a particular policy outcome in any particular area.

2.32 There are also a number of measures which will eventually result in changes to particular policy areas, in particular the repeal of retained EU law and the creation of a new framework in FSMA to regulate financial markets.

2.33 These measures are enacting provisions, in that they will not result in any immediate change. That is because, while retained EU law is repealed by the primary legislation, that repeal will not be commenced by HM Treasury until the regulators have prepared the necessary rules which will replace it, and HM Treasury has made any necessary restatements or brought the relevant activities into FSMA.

2.34 Only when the powers for HM Treasury or for the regulators are exercised will there be a regulatory impact on firms. The regulators are operationally independent. Therefore, it is neither possible nor appropriate for the government to quantity the impact of any possible rule changes, as doing so would pre-judge the independent consultations and decisions of the regulators, or what future policy decisions will be made through secondary legislation.

2.35 The process of repealing retained EU law, and the regulators replacing it in their rules is expected to take a number of years. All subsequent secondary legislation and regulator rules made as a result of the measures in the Bill will be accompanied by the appropriate impact assessment or cost benefit analysis.

2.36 HM Treasury and the regulators have begun consideration of some changes to the existing regulatory requirements in specific areas of regulation. This has been used to provide some case studies to illustrate the types of changes that could be put into effect as a result of the FRF Review measures. Policy development in these areas is still at a relatively early stage, which means that it is generally not possible to quantify the impact of the proposed changes at this stage. As with other areas of financial services regulation, the legislation to deliver these changes will be accompanied by impact assessments.

## FRF Review: Repeal of Retained EU Law

**Problem Under Consideration**

2.37 Financial services regulation needs to be updated regularly to take account of new products and markets, and emerging risks and opportunities.

2.38 Under FSMA, the government is able to bring new activities within the scope of the regulation of the UK's expert regulators, where rules can be updated to reflect changing market practices and risks. During the UK's membership of the EU, and particularly following the global financial crisis, the majority of new financial services regulation in the UK was developed and delivered at an EU level. When the UK left the EU, the body of EU legislation that applied in the UK at the point of exit was transferred onto the UK statute book by the European Union (Withdrawal) Act 2018 (EUWA). This is known as retained EU law.

2.39 HM Treasury undertook a significant programme of secondary legislation to ensure that the body of retained EU law relating to financial services would operate effectively following the UK's withdrawal from the EU, by making the necessary amendments to address any deficiencies arising as a result of exit at the end of the transition period.

2.40 This approach provided stability and continuity in the immediate period after EU exit, but it was never intended to provide the optimal, long-term approach for UK regulation of financial services. In particular, it has led to a complicated patchwork of regulatory requirements across domestic primary and secondary legislation, retained EU law, and regulator rulebooks. And it means that the regulators are often not able to make changes to rules that apply to financial services firms, as the rules are set out in retained EU law, and generally require primary legislation to amend.

2.41 The significant amount of retained EU law on the UK statute book means that UK firms continue to be governed by this patchwork of rules which were not necessarily designed to suit the UK's markets, and which is difficult to keep updated. The UK has world-leading, expert regulators who are currently unable to set the rules that they consider most appropriate in areas which are covered by retained EU law.

2.42 Retained EU law covers a wider range of regulation: everything from capital rules for banks and credit institutions, the rules governing derivative products, to conduct on financial markets. This means that rules in retained EU law apply to large banks and insurers, but also to a range of firms who may not consider themselves to be financial services firms at all, but who sometimes interact with financial markets.

2.43 This is contrary to the approach in FSMA, which delegates the setting of regulatory standards to expert, operationally-independent regulators, working within an overall policy framework set by government and Parliament.

**Rationale for Intervention**

2.44 As part of the FRF Review, the government has identified hundreds of pieces of retained EU law relating to financial services, including 32 principal EU Regulations, more than 20 EU Directives which have been incorporated into UK law, and more than a hundred pieces of EU tertiary legislation. Implementing and maintaining this body of law required around 200 pieces of UK secondary legislation. Compliance with this regulation is a significant regulatory burden on financial services firms.

2.45 Retained EU law covers a wider range of regulation: everything from capital rules for banks and credit institutions, the rules governing derivative products, to conduct on financial markets. This means that rules in retained EU law apply to large banks and insurers, but also to a range of firms who may not consider themselves to be financial services firms at all, but who sometimes interact with financial markets. The UK regulatory system needs the ability to appropriately tailor regulation to reflect the specifics of the UK financial services sector.

2.46 Through the FRF Review, the government has not attempted to review each piece of retained EU law to understand its effect, and such a review would not be practical. However, the government has undertaken a number of reviews into specific parts of retained EU law, including the Wholesale Market Review, the Solvency II Review, and Lord Hill's UK Listings Review, to consider how retained EU law in these areas should be amended. These reviews demonstrate a clear need to reform retained EU law in financial services, and only represent a fraction of the retained EU law which exists on the statute book – the Solvency II Review, for example, considers reforms stemming from a single EU Directive. A case study of how the reforms suggested by Lord Hill in his review into how to improve the UK's prospectus regime is included at the end of this section.

2.47 The effect of having these regulatory requirements in legislation is that it is difficult and time-consuming to update, and places substantial resource pressures on Parliament which is asked to consider a large volume of highly technical provisions, often with the status of primary legislation.

2.48 These technical provisions were set, often several years ago, in response to the financial crisis, in a way that reflected EU markets as a whole, to suit a variety of needs amongst the 28 different Member States. As the various government reviews into individual parts of retained EU law have demonstrated, this law could be better suited to the UK and is at risk of becoming out of date in many places.

2.49 While this retained EU law remains in place, the expert regulators are not properly able to carry out the role that Parliament has given them under FSMA.

**Policy Objective**

2.50 The overall policy objective is to establish a comprehensive FSMA model. That means applying the FSMA model to areas which are currently covered by retained EU law, so that the government and Parliament establish the framework and objectives for the regulators, and the regulators generally design the detailed rules that apply to firms. The government has judged that the FSMA model of regulation continues to be the most appropriate model for the regulation of financial services in the UK.

2.51 As a result, the regulators will generally take responsibility for the regulatory provisions which apply to firms, and which are currently set out in retained EU law. This will enable a UK regulatory regime which is properly tailored for the UK markets, and which can be updated in an agile manner to reflect to changing trends and practices.

2.52 This will be accomplished by repealing most retained EU law relating to financial services and replacing it with a more appropriate framework of financial services regulation.

**Description of options considered**

2.53 Option 0 (Do nothing) - If no action is taken, the regulation of the UK's financial services sector will continue in its current form. That means it will continue to be a mixture of FSMA regulation, and the EU regulation which was in place at the point of leaving the EU.

2.54 This would not be practical, as in those areas covered by retained EU law, the rules which govern the UK's financial services sector, and the UK's financial markets, would not be able to keep pace with international developments and changing market practices. This could stifle the development of new services and result in less efficient markets, or inadequate protections for users of financial services. This would ultimately impact the whole economy and the international competitiveness of the UK's financial services sector.

2.55 Under this scenario, most rule changes would need to be made by the government via primary legislation, rather than the regulators being able to adapt their rules as they can under the FSMA model. This would make the legislation difficult and time-consuming to update (with potential harms going unaddressed while the legislation is developed), and would place substantial resource pressures on Parliament which is asked to consider a large volume of highly technical provisions.

2.56 Many UK firms would continue to be regulated for an indefinite period of time by rules set by the EU, and which were calibrated to suit a wide variety of financial services sectors across different member states, rather than within a framework of agile rulemaking which has been designed to suit the UK's own financial services sector.

2.57 This means that the UK's expert regulators will not be able to act appropriately to improve the rules based on the needs of UK markets, or to update standards efficiently in response to changing market conditions and emerging risks. As a result, there would be a risk that regulation would become out-of-date and ineffective, thus, potentially threatening the standing of the UK as a world-leading financial centre and undermining the government's wider vision for the financial services sector.

2.58 Option 1 (Preferred Option) – establish a comprehensive FSMA model of financial services regulation. This involves repealing most retained EU law relating to financial services, in order to establish a comprehensive FSMA model of regulation.

2.59 This will remove the need to make technical updates to retained EU law through legislation, and ensure that the rules which apply in the UK are those which are most suitable to UK markets.

2.60 The independent regulators will set detailed rules for the areas of regulation currently covered by retained EU law once that retained EU law is deleted. The regulators Government and Parliament will retain responsibility for setting the regulatory perimeter and framework in which the regulators operate.

2.61 This transfer of responsibilities will take place over a number of years. Consequently, the government is taking powers to amend and restate retained EU law in the interim period to ensure that it functions effectively for UK markets prior to deletion.

2.62 The government also needs to ensure that key public policy priorities are considered. This will be achieved through the 'have regards' power which will enable HM Treasury to outline areas which the regulators must consider when making rules in specific areas of regulation. The government also needs to ensure that key areas of financial services continue to be regulated. This will be achieved through the obligations power which enables HM Treasury to obligate the regulators to make rules in certain areas.

2.63 A new regulatory framework, the Designated Activities Regime (set out in more detail below), will also be created to bring activities currently regulated in retained EU law into domestic regulation in a proportionate way.

**Outline of preferred policy**

Removal of Retained EU law:

2.64 The Bill will repeal a large amount of retained EU law relating to financial services that contains rules applying to firms, and related provisions.

2.65 This Bill also introduces a number of provisions to allow retained EU law to be replaced in a way that creates a comprehensive FSMA model of regulation. Under the FSMA model, Parliament through legislation sets the overall approach to financial services regulation including the regulators' objectives. Parliament also establishes the parameters within which HM Treasury sets the 'regulatory perimeter' through secondary legislation, specifying which financial activities should be regulated and the circumstances in which regulation should apply.

2.66 In order to ensure that HM Treasury retains responsibility for maintaining the perimeter, as established by FSMA, the Bill gives HM Treasury the ability to "restate" any part of retained EU law (i.e. to include it in domestic legislation with any necessary modifications).

2.67 This will ensure that structural or framework-related elements of retained EU law that will continue to be important under the comprehensive FSMA model are maintained in legislation. This approach will mean that the financial services regulators are able to make the detailed rules which apply to firms within the existing domestic framework set by government and Parliament, supplemented by restated provisions where needed.

2.68 Examples of these provisions include:

a. Key definitions that make up elements of the financial services regulatory framework and therefore what activities are being regulated. For example, definitions of different types of financial market infrastructure. This will ensure that the government continues to be responsible for the finely balanced decision on what activity is regulated across the financial services sector.

b. Existing rule-making powers for the regulators and powers to supervise and enforce their rules effectively. This will ensure that the regulators can continue to make and supervise rules relating to these areas, avoiding any regulatory gap. This is in line with the FSMA model where the regulators' powers are established in legislation.

c. The ability for HM Treasury to assess whether other jurisdictions have regulatory requirements equivalent to those in the UK. This is consistent with the government's responsibility for deference arrangements.

2.69 The process of moving from retained EU law to a comprehensive FSMA model of regulation will be a significant undertaking, and will take a number of years. There are hundreds of pieces of retained EU law relating to financial services, and some of the most detailed pieces can be several hundred pages long. Following the delivery of these proposed powers, a subsequent programme of secondary legislation will be required to give effect to the changes. This means that Parliament will have the opportunity to scrutinise the legislation which enables these changes, and subsequently, the statutory instruments giving effect to these changes. The government and the regulators will work together closely on this, to ensure that there is a clear and transparent approach to transition, that provides continuity and stability and appropriately manages any impact on firms or consumers that would result from the changes.

Have regards and obligations:

2.70 The Bill will also make some enhancements to the FSMA framework, to ensure that important public policy issues can continue to be appropriately factored into financial services regulation. While the UK was a member of the EU, and a significant amount of legislation was negotiated in Brussels, the UK government could ensure that such issues were considered, and EU institutions would also consider these issues. Under the FSMA model, the regulators must act as they consider appropriate to advance their statutory objectives – limiting the extent to which any wider public policy issues, not covered by their statutory objectives, can be considered.

2.71 The Bill will give HM Treasury the power to:

a. Require the regulators to "have regard" to things specified by HM Treasury when they are making rules. For example, in the FS Act 2021, HM Treasury required that the PRA, when making CRR rules, have regard to relevant standards recommended by the Basel Committee on Banking Supervision.

b. Place obligations on the regulators to make rules in relation to specific areas of regulation. For example, in the FS Act 2021, HM Treasury required that the FCA make rules applying to FCA investment firms which imposed a variety of prudential requirements, including requirements relating to types and amounts of capital and liquid assets such firms must hold to manage risk.

2.72 The responses to the November 2021 consultation that expressed a view on this issue were highly supportive of the proposal to give HM Treasury the ability to introduce 'have regards' and obligations, although many also suggested safeguards and concerns around independence. The responses highlighted the general consensus that there is a need for the government to be able to set direction in regards to the regulators' rulemaking in light of the increased responsibilities given to the regulators.

Transitional powers:

2.73 It will take a number of years to complete the process of repealing retained EU law. Some large bodies of retained EU law will take a long time to transfer as they require consultation and engagement with both the regulators and industry. Therefore, it is likely that some elements or specific provisions within retained EU law will become ineffective or out of date before the repeal can be commenced. Consequently, a power that enables HM Treasury to make targeted changes to retained EU law to ensure that it continues to function effectively is necessary.

2.74 During this transitional period before repeal has fully taken effect, the regulators will be restricted in how they are able to pursue their statutory objectives. For example, a regulator may consider that disclosure requirements should be enhanced to protect consumers against an emerging risk, but if those requirements are set out in retained EU law with the status of primary legislation, they may be unable to do so.

2.75 As set out above, updates to retained EU law generally require primary legislation. The government does not consider that it is appropriate to continue to amend retained EU law through primary legislation when, ultimately, that retained EU law will be repealed.

2.76 In order to ensure that regulatory requirements can be updated appropriately during this transitional period, the Bill will give HM Treasury a power to modify retained EU law before its repeal is given effect. HM Treasury will be able to make these modifications in order:

a. To promote the effective functioning of financial markets; promote effective competition; and promote the long-term growth and international competitiveness of the UK economy and the financial services sector.

b. To protect consumers and insurance policy holders; to protect and enhance the stability and integrity of the UK financial system and the safety and soundness of UK financial services firms; and to provide for effective enforcement, investigation, and supervision.

c. To implement international standards and practices – like updated Basel standards.

2.77 The power will also be available for technical purposes, such as making retained EU law clearer, or delaying or extending EU provisions which are not yet in force such as the third country benchmark regime which was delayed through the FS Act 2021.

2.78 The purposes closely relate to the regulators' statutory objectives. This will ensure that HM Treasury is effectively able to pursue these aims during the transitional period, ensuring that retained EU law can be updated and is not detrimental to UK firms.

**Methodology**

2.79 The changes proposed through the FRF Review are to the overall framework and will, therefore, be for the regulators to implement. As such, the costs and benefits of operationalising these measures will be determined by the PRA and the FCA. However, the government has set out indicative costs for individual measures where this is possible.

2.80 The government's proposals outlined above will not immediately impact firms. While retained EU law is repealed by the primary legislation, that repeal will not be commenced by HM Treasury until the regulators have prepared the necessary rules which will replace it, and HM Treasury has made any necessary restatements. As set out above, the government expects this process to take a number of years.

2.81 Although the government has included a qualitative assessment of the potential impacts of the FRF Review, it has not been possible to quantify the final impacts of the FRF Review at this stage, as this will depend on the future exercise of the powers conferred on HM Treasury by this Bill, and on future policy decisions of HM Treasury and the financial services regulators.

2.82 As the regulators are operationally independent, it is not possible for the government to prejudge the rules they will make. Therefore, it is not possible to quantify the cost of the replacement of retained EU law at this stage. Where final impacts are dependent on the outcome of policy decisions which sit within the remit of the independent financial services regulators, as explained in the introduction of this impact assessment, HM Treasury is content that in such cases, the regulators will have in place appropriate mechanisms to consider the impact of such decisions. More information on the FCA and PRA's approach to assessing costs and benefits, including how that will be bolstered by measures in this Bill can be found in the introduction section of this Impact assessment.

2.83 At the point of secondary legislation, and in line with the government's approach to better regulation under the Better Regulation Framework, HM Treasury will make efforts to further consult on and understand the potential further impacts of the FRF Review, including through appropriate stakeholder engagement. More detailed qualitative and quantitative cost-benefit analyses are expected to be covered in the Impact Assessments accompanying the relevant secondary legislation enabled by the Bill. HM Treasury will also engage with the RPC, prior to the submission of impact assessments produced to accompany future secondary legislation where appropriate.

2.84 This is in line with the approach taken in the impact assessment of the Taxation (Cross Border Trade) Act 2018, which took a similar approach – although, as previously explained, in the case of this Bill, many of the rules will be replaced by the regulators who will conduct their own cost benefit analysis.

**Policy Costs**

2.85 This legislation will enable large parts of retained EU law to be replaced with regulator rules within a framework set by government and Parliament, and provide powers for HM Treasury to manage this transitional phase. The government expects that, over time, the regulators will introduce rules which are more suited to UK markets. However, the nature of these rules will be a matter for the independent regulators to set in keeping with their objectives, and any obligations and 'have regards'. In some cases, it may be appropriate for the regulators to ensure continuity with the current provisions in retained EU law. However, there will also be instances where it is appropriate for the regulators to take the opportunity to tailor the rules to reflect the specifics of UK markets, and to make targeted improvements, in line with their objectives.

2.86 Only when retained EU law is replaced will there be a regulatory impact on firms. The regulators are operationally independent. Therefore, it is neither possible nor appropriate for the government to quantity the impact of any possible rule changes, as doing so would pre-judge the independent decisions of the regulators. However, the government has identified several likely costs below, although the exact nature of them is not quantifiable at this time:

a. Familiarisation: While it is not possible to make a quantitative assessment at this stage, it is likely that there will be familiarisation costs for firms currently required to follow rules set out in retained EU law. This is because those rules will be repealed by this Bill, and so firms will need to familiarise themselves with the new rules.

b. The exact degree of these costs will depend on the exact rules made by the regulators, and to extent to which they differ from those in retained EU law at the moment.

c. Engagement with the rulemaking process: The government also expects some costs for industry during the rulemaking process. When the regulators make rules, they are required by FSMA to consult publicly on proposed rule changes. It is likely that some members of industry will wish to engage with this consultation process, for example by preparing consultation responses, which will result in a cost for those firms.

d. Other potential costs: it is possible that in some instances the regulators could chose to make rules that impose other costs on firms, beyond those currently imposed on firms by retained EU law. As the repeal covers a wide range of policy areas, this could include things like capital requirements, reporting requirements, IT costs, etc. However, as set out below, generally the government would expect the rules that the regulators make to result in reduce costs to firms because they will be better tailored to UK markets.

e. Regulator costs: the government acknowledges that the approach of repealing retained EU law in order to establish a comprehensive FSMA model will result in addition rulemaking responsibilities for the regulators in areas where they are not currently able to make rules.

2.87 This additional responsibility could result in costs, although the exact nature of these will depend on the choices taken by the regulators. For example, the regulators could decide to raise fees directly from firms, resulting in direct costs for industry, or this could result some reforms moving at a slower pace than they would have otherwise done.

2.88 The nature of the effect on the regulators when retained EU law is repealed will depend on the choices they make and the speed at which retained EU law is repealed. It may be possible to quantify such costs during the production of an Impact Assessment for any of the resulting secondary legislation and through the regulators own cost benefit analysis.

**Policy Benefits**

2.89 As the measures relating to the FRF Review are designed to deliver a framework for the future, benefits to businesses will be ongoing rather than one-off.

2.90 The Bill will mean that, in future, the majority of firm-facing rules are located in the regulators' rulebooks, creating a more comprehensible framework which benefits both industry and consumers. Respondents to the November 2021 consultation recognised this, highlighting their belief that the FSMA model remains the appropriate basis for regulation, supporting high regulatory standards. Responses also highlighted that this system is likely to be efficient and effective, leading to a more agile framework that enables the UK to keep pace with international regulatory standards in a way that is highly accessible to industry.

2.91 As already explained, it is not possible to quantify the nature of the benefits of repealing retained EU law. However, there are several benefits associated with the approach:

a. Appropriate UK regulation: Businesses that are subject to financial services regulation and all users of financial services products will benefit from the flexibility of the reformed financial services regulation and the fact that expert, independent regulators will be responsible for making regulations, ensuring that they are designed specifically for the UK financial services sector, within a framework set by government and Parliament. As individual sections of retained EU law are repealed, the benefits of having an up-to-date, flexible framework within which to operate will immediately be felt by firms. Several respondents to the consultation also noted that having a more coherent approach to regulation, with rules all in the regulators rulebooks, would provide benefits in terms of making the rules easier for firms to follow.

b. Agile rulemaking: By repealing retained EU law so that the detailed rules firms must follow are generally set directly in regulator rulebooks, the regulators will be able to respond quickly to changing markets and alter their

rules accordingly without the need for legislation. Firms will benefit from this as it will ensure that rules remain up to date.

c. The power for HM Treasury to modify retained EU law before it is repealed to make immediate improvements, where appropriate. For example, HM Treasury expects to deliver a number of measures announced as part of the Wholesale Markets Review in this manner, in addition to changes in this Bill itself.

d. Public policy priorities in regulator rulemaking: The 'have regards' and obligations powers will provide the government with the means to provide additional direction to the regulators' rulemaking. Firms will benefit from this as it will ensure that important public policy issues are considered and that rules reflect current market circumstances.

2.92 Repealing retained EU law and replacing it with domestic legislation and rules will provide an opportunity to review the regulatory requirements on firms, and consider whether they are still necessary, whether they are having their intended impact, and whether they are proportionate. In aggregate, the government expects this to result in more proportionate and streamlined requirements, that don't reduce the safety and soundness of firms, or protection for consumers.

**Assumptions, limitations, and considerations**

2.93 Ultimately, as explained above under methodology, the impact of rules made by the regulators when compared to retaining the current rules will depend on the decisions made by the regulators as part of their full policymaking processes. The impact of secondary legislation passed as a result of this Bill can also not be determined at this stage.

2.94 Similarly, the benefits of the legislation depend on the rules made by the regulators which cannot be estimated or quantified at this stage. However, as a result of the fact that the regulators will be able to make rules more suited to UK markets, it is likely that these will benefit firms. It is also not possible to quantify the benefits of secondary legislation that will be passed as a result of this Bill. However, the fact that the proposed powers are designed to ensure that legislation remains up to date and key public policy priorities are reflected is likely to benefit industry.

**Small and MicroBusiness Assessment (SaMBA)**

Number and distribution of businesses in scope of the regulation

2.95 This measure repeals retained EU law relating to financial services so that it can be replaced with the appropriate rules and regulations in UK law, and gives HM Treasury powers to modify and restate it. There will be no immediate direct impact upon small and microbusinesses (SMBs) at the point of Royal Assent as this measure will only confer on HM Treasury the ability to exercise these powers through future secondary legislation. However, the department expects the future exercise of the powers in this measure will have an impact on small and microbusinesses.

2.96 At this stage it is not possible to accurately quantify the number of SMBs who will be impacted by the exercise of these powers. Any impact will depend on future policy decisions made by the department or by financial services regulators who will take on a large amount of the responsibility for replacing the regulatory requirements that currently sit in the retained EU law repealed by the Bill. To attempt to accurately estimate the number of small and microbusinesses impacted at the stage of secondary legislation would require HM Treasury to pre-judge policy decisions to be made in future by HM Treasury and by the independent financial services regulators. Many of the changes will be subject to consultation before decisions are made. Any estimate given through such an enterprise would likely be inaccurate and out of date by the time the impact is felt by SMBs due to future, as yet unknown, policy decisions and potential unexpected changes in the UK's financial services markets.

2.97 However, given retained EU law relating to financial services mostly governs the activity of financial services firms, firms which primarily operate in financial services, or which are currently regulated by the UK's financial services regulators, are the firms most likely to be in scope by the future exercise of the powers in this measure.

2.98 According to data provided by the PRA, the PRA currently regulates 1432 financial services firms, including 409 Credit Unions, 371 firms subject to the Capital Requirements Regulation (CRR firms) and 652 insurers. All 409 Credit Unions (100 per cent) can be classified as SMBs (firms with less than 50 employees). The PRA does not hold data on employee size for all CCR and insurance firms. However, using a threshold of turnover of less than £10.2 million the PRA estimates that 25 CRR firms are SMBs[9] (6.74 per cent) and at least 328 insurers are SMBs (50.3 per cent)[10]. These SMBs may be impacted by the future exercise of the powers in this measure.

2.99 Similarly, the FCA currently regulates over 50,000 firms. The FCA does not hold comprehensive data on the number of employees in these firms. Not all FCA regulated firms are required to report data to the FCA, and so only 38,599 out of the 50,000 firms regulated by the FCA have submitted turnover data for the 2021 financial end. Out of these 38,599 reporting firms, 34,533 (89%) can be classified as 'small' (turnover of less than or equal to £10.2 million). This data is based on the 2021 financial end for FCA regulated firms with an active status and where the data is stored and accessible from the FCA's data lake. It does not cover data reported by firms who no longer have an active status. Where there are gaps, the FCA have looked to try to fill these using information from a survey conducted in response to the COVID-19 situation, though it should be noted that not all firms completed this. Using 89% as a proxy, HM Treasury estimates that approximately 44,500 SMBs are currently regulated by the FCA.

Do the impacts fall disproportionately on small and microbusinesses?

[9] This excludes UK incorporated banks which are part of a wider banking group.

[10] The PRA does not hold data on turnover amount for firms in the Temporary Permissions Regime (TPR) , firms in Supervised Run-Off (SRO), or for Gibraltar authorised insurers and did not provide an estimate of how many of these firms are SMBs.

2.100 As explained above, it has not been possible to accurately quantify businesses within scope of this measure at this stage. For similar reasons it has also not been possible to quantify the costs and benefits to businesses of this measure and what proportion of these will fall on SMBs. This will depend on the future exercise of the powers conferred on HM Treasury by this measure, and on the future policy decisions of HM Treasury and the financial services regulators. Therefore, the impact on SMBs and whether this is disproportionate will need to be assessed and considered when HM Treasury exercises the powers conferred on it by this measure in future secondary legislation. As part of these future assessments, the government endeavours to comprehensively consider where possible:

a. A quantitative estimation of the number SMBs impacted by the measures in that secondary legislation, including the proportion this makes up of the relevant sector;

b. An appropriate quantification of the costs and benefits to SMBs;

c. Consideration of whether the relevant policy objectives could be achieved if SMBS were to be exempted from the measures.

d. If SMBs are not to be exempted, consideration of whether measures can be taken to mitigate the impact on SMBs.

2.101 HM Treasury looks forward to continuing to engage with RPC throughout this stage.

2.102 As mentioned previously the final impact on SMBs of the future exercise of the powers conferred on HM Treasury in this measure may be dependent on the outcome of policy decisions which sit within the remit of the independent financial services regulators. For example, where HM Treasury confers, via secondary legislation, a rulemaking power over an area currently regulated by retained EU law. As explained in the introduction of the impact assessment, the department is content that in such cases, the regulators will have in place appropriate mechanisms to consider the impact of such decisions on SMBs.

2.103 More information on the FCA and PRA's approach to assessing costs and benefits to business, including how that will be bolstered by measures in this Bill can be found in the introduction to this impact assessment under Approach to small and micro business assessment.

*Qualitative assessment of potential future costs and benefits on SMBs*

2.104 Although the government is unable to give an accurate quantitative assessment of future costs and benefits of this measure on SMBs at this stage given the various unknowns, the government has included the following qualitative assessment of how the potential expected costs and benefits for SMBs arising from the exercise of the powers in this measure in future.

*Benefits to SMBs*

2.105 As the measures relating to the FRF Review are designed to deliver a framework for the future, benefits to all businesses including SMBs will be ongoing rather than one-off. The powers in this measure will allow the UK to move to a comprehensive FSMA

model of regulation following the repeal of retained EU law. Under FSMA the majority of firm-facing rules are located in the regulators' rulebooks, creating a more comprehensible framework which benefits both industry and consumers. HM Treasury expects this will be beneficial for SMBs in the following ways:

a. SMBs which are subject to financial services regulation, and which are users of financial services products will benefit from the flexibility of the reformed financial services regulation and the fact that the UK's expert, independent regulators will be responsible for making regulations, ensuring that they are designed specifically for the UK financial services sector. As individual sections of retained EU law are repealed, the benefits of having an up-to-date, flexible framework within which to operate will immediately be felt by all firms including SMBs. Several respondents to the government's November consultation noted that having a more coherent approach to regulation, with rules all in the regulators' rulebooks, would provide benefits in terms of making the rules easier for firms to follow. This clarity should be particularly beneficial for SMBs who are less able to absorb fixed costs associated with acquiring the time and resource to understand complicated regulation.

b. The repeal of retained EU law will make way for the financial services regulators to set direct regulatory requirements for firms in regulator rulebooks. The regulators will be able to respond quickly to changing markets and alter their rules accordingly without the need for legislation, and without being bound by EU set regulation. All firms including SMBs will benefit from this as it will ensure that rules remain up to date with both emerging opportunities for firms and potential challenges within UK markets.

c. Repealing retained EU law and replacing it with domestic legislation and rules will provide an opportunity to review the regulatory requirements on firms, and consider whether they are still necessary, whether they are having their intended impact, and whether they are proportionate. In aggregate, this is expected to result in more proportionate and streamlined requirements, that don't reduce the safety and soundness of firms, or protection for consumers. More proportionate and streamlined requirements will be of particular benefit to SMBs subject to this regulation who are less able to absorb the fixed costs associated with regulatory burdens.

*Costs to Small and Microbusinesses*

2.106 While it is not possible to make a quantitative assessment at this stage, it is likely that there will be familiarisation costs for those SMBs who are currently required to follow rules set out in retained EU law. This is because those rules will be repealed by this Bill and replaced, and so firms will need to familiarise themselves with the new rules. The scale of these costs will depend on the exact rules made by the regulators, and the extent to which they differ from those currently in retained EU law.

2.107 Some costs for industry are also expected during the rulemaking process. When the regulators make rules, they are required by FSMA to consult publicly on proposed rule changes. It is likely that some SMBs will wish to engage with this consultation

process, for example by preparing consultation responses, which will result in a cost for those firms.

2.108 It is possible that in some instances the regulators could make rules that impose costs on firms, beyond those currently imposed on firms by retained EU law. As the repeal covers a wide range of policy areas, this could include things like capital requirements, reporting requirements, IT costs, etc. However, as set out below, generally the government expects the rules that the regulators make to result in reduced costs to firms because they will be better tailored to UK markets, so it is unlikely that firms will face higher ongoing costs as a result of the changes. However, there may be some transitional costs to adapting to any such changes to the rules (such as changing their IT systems or process to reflect the change).

2.109 The government acknowledges that the approach of repealing retained EU law in order to establish a comprehensive FSMA model will result in addition rulemaking responsibilities for the regulators in areas where they are not currently able to make rules. This additional responsibility could result in costs for SMBs, although the exact nature of these will depend on the choices taken by the regulators. For example, the regulators could decide to raise fees directly from firms, resulting in direct costs for industry. As explained in the introduction of this Impact Assessment under Approach to costs of Regulator levies,the financial services regulators levy fees from authorised firms in order to recover their running costs. When determining the amount of fees levied on authorised firms the regulators must ensure the cost imposed on firms is proportionate to the benefit of regulation, and as such fees are determined with due consideration to the activities and size of authorised firms. The government therefore anticipates that SMBs should not be disproportionately impacted by changes to regulators' levies.

Could small and microbusinesses be exempted while achieving the policy objectives?

2.110 Exempting SMBs from the scope of this measure would require SMBs to remain subject to all retained EU law relating to financial services. This would prevent the government from achieving its policy objective of creating a comprehensive FSMA model of regulation for all of the UK's financial markets and would prevent SMBs from enjoying the benefits of that model and which are outlined above. It would also create a two tier system in UK regulation, with some firms subject to requirements in retained EU law, and some subject to the new requirements. This would be complex to manage, and create cliff-edges for SMBs when they grow. As the government expects the new requirements to better tailored to UK markets, exempting SMBs would prevent them from experiencing the expected benefits.

2.111 At the point of HM Treasury exercising the powers conferred on it by this measure in secondary legislation, the department commits to consider whether it is appropriate to exempt SMBs from any specific requirements that are introduced, for example whether it is appropriate to exempt SMBs from direct regulatory requirements made to replace repealed retained EU law. The government is content that the financial services regulators will also consider whether the impact of their decisions is proportionate on the SMBs they regulate, and consider whether exemption or mitigation is appropriate. More information on the processes the regulators follow

when considering these impacts is included in the introduction to this impact assessment under Approach to small and microbusiness assessment.

Could the impact on small and microbusinesses be mitigated while achieving the policy objectives?

2.112 This measure will not directly impact SMBs at the point of Royal Assent. As such there is no need for mitigations at this stage.

2.113 Appropriate mitigations may be considered for SMBs when making specific changes subsequent to this legislation. This could include, for example, introducing a longer transitional period to mitigate the familiarisation costs associated with changing specific regulations.

Wider impacts on small and microbusinesses

2.114 The powers in this measure will allow the UK to move to a comprehensive FSMA model of regulation tailored specifically for UK markets, and capable of quickly reacting to emerging opportunities and challenges. The government expects this comprehensive and agile regulation of financial services firms will have a beneficial impact on the wider consumers of financial services firms in the UK, including SMBs.

## FRF Review: Designated Activities Regime

**Problem Under Consideration**

2.115 As set out previously, the government intends to repeal retained EU law in order to move to a comprehensive FSMA model of regulation. The FSMA model delegates the setting of regulatory standards to expert, operationally-independent regulators, the PRA and the FCA, working within an overall policy framework set by government and Parliament. Therefore, FSMA must be capable of regulating the wide range of activities currently covered by retained EU law.

2.116 Many activities which are currently regulated through retained EU law are already regulated activities under FSMA. Regulated activities are set by HM Treasury through the Regulated Activities Order (RAO). Many activities were included in this Order as a means of implementing EU law, or such activities were already regulated under FSMA before the EU legislated.

2.117 When retained EU law is repealed, these 'regulated activities' will be regulated entirely according to the existing FSMA model described above. These are generally understood as financial services, typically the kinds of activities which are carried out by banks, insurers, and investments firms, such as accepting deposits or offering investment services.

2.118 However, many activities, particularly since the financial crisis, were brought into regulation through EU legislation, rather than through the RAO, and so are not regulated activities. The government has identified that many of these rules govern the activity of businesses and individuals who engage in financial markets.

2.119 Financial markets represent the intersection between financial services firms and the wider economy. Engaging with these markets can include activities like listing a company on a stock exchange, entering into a derivative contract, or engaging in market activities such as short selling. All these activities are carried out by a wide range of persons, some of whom are not typically authorised by the regulators.

2.120 The government does not consider it appropriate to require all firms engaging on financial markets to become FSMA authorised persons, and to be supervised as if they are offering financial services directly.

2.121 Therefore, the government needs to ensure that the domestic framework is enhanced so that such activities can be regulated in a manner which is suited to these kinds of activities which are carried out by a wider variety of persons on financial markets.

**Rationale for Intervention**

2.122 It is essential that the financial services regulators have the necessary powers to replace the regulatory provisions which apply to businesses and individuals when retained EU law is deleted, within a framework set by Parliament.

2.123 The UK's model of financial services regulation is established by FSMA. However, bringing these activities inside the current framework for regulated activities through the RAO would require all businesses and individuals engaging in financial

markets to become authorised by the regulators, and would bring them into the same kind of regulation which applies to authorised persons such as banks, insurers, and investments firms. The government does not consider this to be a proportionate approach.

2.124 In particular, under the entity-specific RAO model, the entire activity of an authorised firm is supervised and can be regulated. But there are a number of rules put in place by the EU which govern financial markets, and are 'activity-specific', meaning that a firm is required to carry out the activity according to the rules, but there is no requirement for the firm to be actively supervised beyond that.

2.125 Therefore, it is necessary to create a new framework within FSMA for the regulation of activities related to financial markets, so that these activities are regulated in an appropriate manner. As this is a new regulatory framework, it requires primary legislation.

**Policy Objective**

2.126 The key policy objective is to enable the regulation of activities related to financial markets within a regulatory framework which is proportionate to the levels of risk that these types of activities pose.

**Description of options considered**

2.127 Option 0 (Do nothing) - As set out in the previous section of this impact assessment, if no action is taken, the regulation of the UK's financial services sector will continue in its current form: a mixture of FSMA regulation, and the EU regulation which was in place at the point of leaving the EU.

2.128 Under this scenario, most rule changes would need to be made by the government via primary legislation, rather than the regulators being able to adapt their rules as they can under the FSMA model. This would place inappropriate and substantial resource pressures on Parliament.

2.129 The UK's financial services regulation would be incapable of responding quickly to market developments, and the UK's financial services regulators would be unable to pursue their statutory objectives unconstrained by retained EU law.

2.130 This option would also fail to allow for an agile regulatory regime capable of allowing for the proportionate regulation in the future for new financial market activities that aren't suitable to be regulated under the RAO.

2.131 Option 1 (Preferred Option) - The preferred option is to repeal retained law relating to financial services and create a Designated Activities Regime (DAR) in FSMA to enable the regulation of activities related to financial markets. As this requires the creation of a new framework for regulation in FSMA, this measure can only be delivered through primary legislation.

2.132 As set out under the FRF Review: Repeal of Retained EU law measure above, the government intends to repeal retained EU law relating to financial services. For the government to commence the repeal of retained EU law listed in schedule 1 of this

Bill in full, there will need to be appropriate mechanisms in place to allow for the proportionate regulation of areas currently covered by this legislation.

2.133 Many activities related to financial markets came to be subject to EU law as a response to the global financial crisis, when policy makers sought to introduce standardised rules across a number of different activities. It is vital that these activities continue to be subject to appropriate and proportionate regulation, as activities outside the scope of the RAO can still have an impact on financial markets and consumers.

2.134 However, the current FSMA framework for regulating activities through the RAO will not always be an appropriate framework for these activities, as it would require all businesses and individuals engaging in financial markets to become authorised by the regulators.

2.135 In particular, this would require businesses and individuals engaging with financial markets to be brought into a regulatory framework suited for banks, insurers, and investment firms. This could carry with it a significant cost in following requirements which are not proportionate to the risk that businesses and individuals engaging with financial markets pose. In particular, bringing activities within the RAO applies:

a. A requirement to become authorised persons, which would require day to day supervision from financial services regulators.

b. Application of the Seniors Managers and Certifications Regime, which makes key figures inside firms individually responsible for conduct and competence, and which was put in place to ensure senior management could be held to account for future significant business and conduct failures following the 2008 financial crisis.

c. Jurisdiction of the Financial Ombudsman Service.

d. Membership of the Financial Services Compensation Scheme.

2.136 As an example, a large number and wide range of businesses across the economy enter into derivatives contracts. They are often used by businesses to manage the risk of price fluctuations. These businesses can be complex financial services firms or non-financial businesses operating in the real economy. For example, a car manufacturer may enter into metal derivative contracts as a way of protecting itself against a rise in the price of the metals that it needs to purchase, for example. Such activities should remain subject to an appropriate level of regulation. However, it would not be proportionate to make entering into these derivative contracts a regulated activity, because it would require all entities that wish to use these contracts to apply for authorisation from the FCA, with all of the additional obligations that would entail.Given it would therefore be disproportionate to place some activities currently regulated by retained EU law within the current FSMA model, the government would be unable to fully commence the revocation of retained EU law. Furthermore, the UK would be left with no framework in FSMA to effectively regulate these elements of financial market activity. This would lead to several separate regimes for different activities, rather than a coherent model under FSMA. It also wouldn’t allow for an agile regulatory regime capable of allowing for

the proportionate regulation in the future for new financial market activities that aren't suitable to be regulated under the RAO.

2.137 Option 2 (Non-preferred) – The government has considered fully commencing the repeal of retained EU law and bringing all activities involving an interaction with financial markets within the scope of FSMA by specifying them as activities under the RAO. As explained above under Option 1 this would place a disproportionate regulatory burden on businesses and individuals wishing to interact with financial markets but who are not traditional financial services firms. This option would also not address the problem that the UK has no regulatory framework in place to allow for the proportionate, responsive, and agile regulation of similar activities which could emerge in future.

**Outline of preferred policy**

2.138 The Bill will enhance the framework in primary legislation for the regulation of the UK financial services sector to create a comprehensive FSMA model of regulation. As part of this, the government intends to create the DAR so that activities related to financial markets can be regulated within a framework which is better suited to the level of risk that those activities involve.

2.139 This will involve creating a new framework in FSMA, which will apply the FSMA model to these kinds of activities. The FSMA model delegates the setting of regulatory standards to the regulators, working within an overall policy framework set by government and Parliament. In response to HM Treasury's first consultation on the FRF Review in October 2020, consultation respondents agreed with the government's view that the UK's FSMA model is world-leading and that no alternative model provided a preferable approach to financial services regulation. Respondents to HM Treasury's November consultation agreed the creation of the DAR would be a sensible and pragmatic means of allowing the independent financial services regulators to regulate activities within financial markets without imposing a disproportionate regulatory burden on affected firms.

2.140 This will include an empowerment to enable the regulators to make rules relating to a designated activity only, and not other unrelated activities of the firm or person carrying out that activity.

2.141 This will ensure that there is a flexible and proportionate framework for the regulation of the UK's financial markets, once retained EU law has been repealed.

2.142 Therefore, the Bill establishes a regime with the following key elements, in line with the FSMA model:

a. Establishes a framework within FSMA which sets the overall structure and powers for regulation, and applies the relevant regulatory objectives and principles.

b. Sets a prohibition against, or stipulates that carrying out carrying out 'designated' activities must take place in accordance with the relevant rules;

c. Provides a secondary power for HM Treasury to designate activities relating to financial markets modelled on the existing Regulated Activities Order, so that relevant activities can be brought inside this framework. This power will enable HM Treasury to set some requirements directly, and to indicate where the activities must be performed in line with rules made by the FCA;

d. Provides a rulemaking empowerment, which will enable the FCA to make rules in relation to designated activities in line with its objectives and principles.

2.143 The proposal to create such a regime was supported by the results of the governments FRF Review consultation, with a number of respondents noting that such an approach would be more suitable for a number of activities over authorisation. A number of other respondents welcomed the proposal but felt further information was needed before committing to a position.

**Methodology**

2.144 The DAR will be the framework within which activities which are currently regulated directly by retained EU law will be regulated. Therefore, many people carrying out activities related to UK markets are already required to follow the relevant rules set out in retained EU law, and the UK's regulators have already been tasked with supervising and enforcing these rules.

2.145 And so the government does not initially expect significant changes for anyone carrying out activities related to financial markets.

2.146 A key part of the DAR is providing the FCA with an appropriate rulemaking power over activities relating to financial markets. This will ensure that the FCA is able to make the necessary rules in line with their responsibilities under FSMA in relation to financial markets when retained EU law is repealed. That means that all of the costs and benefits of repealing retained EU law, and which are covered in the previous section of this impact assessment, will also apply to designated activities.

**Policy Costs**

2.147 This measure will create a way for HM Treasury to designate certain activities in future and for the UK's independent regulators to set the rules which apply to businesses or individuals directly in relation to these activities within FSMA.

2.148 The government expects that, over time, the regulators will introduce rules which are more suited to UK markets. However, the nature of these rules will be a matter for the independent regulators to set.

2.149 In addition, no activity will be designated in the primary legislation. Rather, HM Treasury will have the power to 'designate' activities, including those which are currently covered by retained EU law, through secondary legislation. This will enable Parliament to scrutinise the designation of each activity.

2.150 HM Treasury is required to carry out an impact assessment when making secondary legislation, and the regulators are required to undertake cost-benefit analyses when

proposing and making new rules. Therefore, the impact of these changes will be determined and communicated during the process of using these powers.

2.151 However, for the purposes of this impact assessment, the government has considered the function and effect of the DAR in order to present a qualitative assessment of the likely costs and benefits from the legislative approach, without prejudging the decisions of either HM Treasury of the regulators in any particular instance.

2.152 As mentioned previously, one function of the DAR is to enable the FCA to make rules once retained EU law has been repealed in relation to financial markets. And so, the costs associated with the repeal of retained EU law, and which are considered in previous sections in more detail, will equally apply here. Those are: familiarisation; engagement with the rulemaking process; and regulator costs.

2.153 In particular, the government expects that familiarisation and the cost of engaging with the regulator rulemaking process may initially be higher where retained EU law is replaced in part through the DAR, rather than through restatement or through other frameworks already in FSMA. This is because the DAR is a new framework, and so it is expected that it will take firms conducting activities on financial markets to a longer period of time to become familiar with the new framework. Although such costs will be offset by the longer term benefits outlined in the next section.

2.154 In relation to regulator costs, in many cases the rules relating to financial markets have been made by the EU, rather than in the UK. As such, many activities which HM Treasury may choose to designate will result in new rulemaking responsibilities for the FCA.

2.155 This additional responsibility could result in costs, although the exact nature of these will depend on the choices taken by the FCA. For example, the FCA could decide to raise fees directly from firms, resulting in costs for industry, or this could result some reforms moving at a slower pace than they would have otherwise done. While this is generally true of all areas where retained EU law is repealed, the government acknowledges that this is likely to be more acute in areas which could in future be regulated through the DAR, although the government expects the longer-term benefits of the DAR to outweigh this.

2.156 While the government has not attempted to pre-judge the decisions that the FCA will make, the government has ensured that the FCA's fee-raising powers will also apply to its activities under the DAR. This means that the FCA will be able to consider the most appropriate way to fund any additional activities, rather than levying further funding from authorised persons alone. However, in many cases the FCA is already charging fees to fund activities related to financial markets – for example, the FCA already charges a fee to approve prospectuses.

2.157 Where the final impact will be dependent on the outcome of policy decisions which sit within the remit of the independent financial services regulators, as explained in the introduction of this impact assessment, HM Treasury is content that the regulators will have in place appropriate mechanisms to consider the impact of such decisions.

2.158 More information on the FCA and PRA's approach to assessing costs and benefits, including how that will be bolstered by measures in this Bill can be found in the introduction to this impact assessment.

2.159 At the point of secondary legislation, and in line with the government's approach to better regulation under the Better Regulation Framework, HM Treasury will make efforts to further consult on and understand the potential further impacts of this measure, including through appropriate stakeholder engagement. More detailed qualitative and quantitative cost-benefit analyses are expected to be covered in the impact assessments accompanying the relevant secondary legislation enabled by the Bill. HM Treasury will also engage with the RPC, prior to the submission of impact assessments produced to accompany future secondary legislation where appropriate.

**Policy Benefits**

2.160 As the DAR is designed to be a framework for the future, benefits to businesses will be ongoing rather than one-off.

2.161 Businesses and persons undertaking designated activities will benefit from a proportionate regulatory framework which is suited to the regulation of UK financial markets. This means that they will not be required to become authorised persons, or be otherwise subject to the kind of broader supervision appropriate for banks and insurers.

2.162 The DAR will enable the regulators to make rules for designated activities, meaning that persons taking part in financial markets will benefit from an agile regulatory framework that can adapt to changing markets and alter their rules accordingly without the need for legislation. And so, firms conducting these activities will benefit from the appropriate UK regulation, and agile rulemaking.

2.163 More broadly, the government expects that the DAR will lead to ongoing improvements to the regulation of financial markets, beyond the areas which are covered in retained EU law. This is because there is currently no framework in FSMA to regulate financial markets, and so the UK will now have the appropriate domestic framework to respond to future issues in financial markets. This will result in effective and proportionate markets regulation on an ongoing basis.

**Assumptions, limitations, and considerations**

2.164 The DAR is designed to be a framework under which activities related to financial markets will be regulated in future. Therefore, it is not possible to accurately predict these benefits quantitatively.

**Small and MicroBusiness Assessment (SaMBA)**

Number and distribution of businesses in scope of the regulation

2.165 This measure introduces a new regulatory framework which allows for the proportionate activity-specific regulation of activities involving an interaction with financial markets in the UK. This measure gives HM Treasury the power to 'designate' an activity, and make regulations and confer rulemaking and

enforcement powers on the FCA in relation to the activity, in secondary legislation. Once designated, any SMB wishing to conduct a designated activity will be required to follow any regulations or rules relating to that activity as made by HM Treasury in secondary legislation, or by the FCA in its rulebook.

2.166 There will be no immediate direct impact upon small and microbusinesses (SMBs) at the point of Royal Assent as this Bill only sets the necessary legislative framework for the DAR. However, the government expects there to be a future impact on SMBs once HM Treasury begins to designate activities in secondary legislation, as some of these activities will be undertaken by SMBs.

2.167 At this stage it is not possible to accurately quantify the number of SMBs who are in scope of the future exercise of the DAR powers in secondary legislation. Any impact will depend on future policy decisions made by the department or by financial services regulators upon whom this measure enables HM Treasury to confer rulemaking powers. A major, and currently unknown, determining factor in which SMBs will be impacted in future by this measure will be the activities HM Treasury chooses to designate. Although HM Treasury has included an illustrative list of the types of activities it may designate in Schedule 3 of this Bill, this is not legally binding and is only intended to give Parliament a sense of the activities HM Treasury could designate. Given the DAR will be an ongoing framework there is a possibility as yet unknown activities involving an interaction with financial markets will emerge in future which HM Treasury will choose to designate.

2.168 To attempt to accurately estimate the number of small and microbusinesses impacted at the stage of secondary legislation would require HM Treasury to pre-judge policy decisions to be made in future by HM Treasury and by the independent financial services regulators. Many of the changes will be subject to consultation before decisions are made. Any estimate given through such an enterprise would likely be inaccurate and out of date by the time the impact is felt by SMBs due to future, as yet unknown, policy decisions and potential unexpected changes in the UK's financial services markets.

2.169 However, given the DAR will be used for the regulation of activities involving an interaction with financial markets in the UK, firms which primarily operate in financial services, or which are currently regulated by the UK's financial services regulators, are likely to be in scope by the future exercise of the powers in this measure.

2.170 According to data provided by the PRA, the PRA currently regulates 1432 financial services firms, including 409 Credit Unions, 371 Capital Requirements Regulation (CRR) firms and 652 insurers. All 409 Credit Unions (100 per cent) can be classified as SMBs (firms with less than 50 employees). The PRA did not have data on employee size for all CCR and insurance firms. However, using a threshold of turnover of less than £10.2 million the PRA estimate 25 CRR firms are SMBs[11] (6.74 per cent) and at

[11] This excludes UK incorporated banks which are part of a wider banking group.

least 328 insurers are SMBs (50.3 per cent)12. The government anticipates that these SMBs may be impacted by the future exercise of the powers in this measure.

2.171 Similarly, the FCA currently regulates over 50,000 firms. The FCA does not hold comprehensive data on the number of employees in these firms. Not all FCA regulated firms are required to report data to the FCA, and so only 38,599 out of the 50,000 firms regulated by the FCA have submitted turnover data for the 2021 financial end. Out of these 38,599 reporting firms, 34,533 (89%) can be classified as 'small' (turnover of less than or equal to £10.2 million). This data is based on the 2021 financial end for FCA regulated firms with an active status and where the data is stored and accessible from the FCA's data lake. It does not cover data reported by firms who no longer have an active status. Where there are gaps, the FCA have looked to try to fill these using information from a survey conducted in response to the COVID-19 situation, though it should be noted that not all firms completed this. Using 89% as a proxy, HM Treasury estimates that approximately 44,500 SMBs are currently regulated by the FCA. The DAR is intended to allow for the appropriate, proportionate regulation of activities without requiring anyone that wishes to undertake those activities becoming an authorised person. Many of the activities that may be covered by the DAR may therefore be undertaken by firms that are not financial services firms, and therefore by SMBs that are not financial services firms. As such the government anticipates that SMBs which are not financial services firms may also be impacted by this measure. As explained previously, it is not possible to quantify this at this time as it will be dependent on which activities HM Treasury chooses to designate in future as these policy decisions are yet to be taken.

Do the impacts fall disproportionately on small and microbusinesses?

2.172 As explained above, at this stage, it is not possible to quantify the number of businesses which will be impacted by this measure as a result of future secondary legislation that it enables, including the number and proportion of which will be SMBs. For similar reasons it is not possible to quantify the potential costs and benefits which may ultimately derive form this measure on businesses and what proportion of these will fall on SMBs. This will depend on the future exercise of the powers conferred on HM Treasury by this measure, and on the future policy decisions of HM Treasury and the financial services regulators. The impact on small and microbusinesses will therefore need to be assessed and considered when HM Treasury exercises the powers conferred on it by this measure in future secondary legislation. At the point of secondary legislation, once the necessary policy decisions have been made, the department commits to conducting a comprehensive impact assessment considering the following:

a. A quantitative estimation of the number SMBs impacted by the measures in that secondary legislation, including the proportion this makes up of the relevant sector;

[12] The PRA does not hold data on turnover amount for firms in the Temporary Permissions Regime (TPR) , firms in Supervised Run-Off (SRO), or for Gibraltar authorised insurers and did not provide an estimate of how many of these firms are SMBs.

b. An appropriate quantification of the costs and benefits to SMBs;

c. Consideration of whether the relevant policy objectives could be achieved if SMBS were to be exempted from the measures.

d. If SMBs are not to be exempted, consideration of whether measures can be taken to mitigate the impact on SMBs.

2.173 The department looks forward to continuing to engage with RPC throughout this stage.

2.174 As mentioned previously the final impact on SMBs of the future exercise of the powers conferred on HM Treasury in this measure may be dependent on the outcome of policy decisions which sit within the remit of the independent financial services regulators. For example, where HM Treasury confers, via secondary legislation, a rulemaking power over an area currently regulated by retained EU law. As explained in the introduction of this impact assessment, the department is content that in such cases, the regulators will have in place appropriate mechanisms to consider the impact of such decisions on SMBs.

2.175 More information on the FCA and PRA's approach to assessing costs and benefits to business, including how that will be bolstered by measures in this Bill can be found at in the introduction of this impact assessment under Approach to small and micro business assessment.

*Qualitative assessment of potential future costs and benefits on SMBs*

2.176 Although the government is unable to give an accurate quantitative assessment of future costs and benefits of this measure on SMBs at this stage given the various unknowns, the government has included the following qualitative assessment of how the potential expected costs and benefits for SMBs arising from the exercise of the powers in this measure in future.

*Benefits to small and microbusinesses*

2.177 As the DAR is designed to be a framework for the future, benefits to SMBs will be ongoing rather than one-off.

2.178 SMBs undertaking designated activities will benefit from a proportionate regulatory framework which is suited to the regulation of UK financial markets. The DAR has been designed to allow for the proportionate regulation of these activities without requiring those undertaking them to become authorised persons under FSMA. An alternative approach, that the government considered and rejected, would be to require any firm undertaking these activities to be authorised. This was rejected because would be disproportionate and impose a significant regulatory burden on firms who are not financial services firms but who wish to engage with financial markets – and that burden would have disproportionately affected SMBs due to the fact that many costs of authorisation do not scale linearly with size. The DAR will allow for the 'activity-specific' proportionate regulation of these firms, meaning SMBs will be able to continue to engage with the UK's financial services without

being subject to authorisation under FSMA and the burdensome requirements that entails.

2.179 For activities currently regulated by retained EU law, which become designated activities under the DAR, there is the potential for SMBs undertaking these activities to benefit from the fact that the regulators will have the opportunity to replace existing regulation with more appropriately tailored regulation, designed for UK markets.

*Costs to SMBs*

2.180 The government expects that there will be familiarisation costs associated with moving from retained EU law to new regulations under the DAR, and also a cost of engaging with the regulators' consultations on any changes to the rules.the regulator rulemaking process. The government is aware that SMBs may be disproportionally impacted given they are less able to absorb the fixed costs associated with familiarisation. However, the government expects such costs will be offset by the longer-term benefits outlined above.

2.181 In relation to regulator costs, in many cases the rules relating to financial markets have been made by the EU, rather than in the UK. As such, many activities which HM Treasury may choose to designate will result in new rulemaking responsibilities for the FCA. This additional responsibility could result in costs, although the exact nature of these will depend on the choices taken by the FCA. For example, the FCA could decide to raise fees directly from firms, resulting in direct costs for SMBs wishing to conduct designated activities. However, generally the government expects the rules that the regulators make to result in reduced costs to firms because they will be better tailored to UK markets, so it is unlikely that firms will face higher ongoing costs as a result of the changes. However, there may be some transitional costs to adapting to any such changes to the rules (such as changing their IT systems or process to reflect the change).

2.182 While the government has not attempted to pre-judge the decisions that the FCA will make, the government has ensured that the FCA's fee-raising powers will also apply to its activities under the DAR. This means that the FCA will be able to consider the most appropriate way to fund any additional activities, rather than levying further funding from authorised persons alone. However, it should be noted that in many cases the FCA is already charging fees to SMBs in order to fund activities related to financial markets, for example, the FCA already charges a fee to approve prospectuses.

Could small and microbusinesses be exempted while achieving the policy objectives?

2.183 Exempting SMBs from this measure at this stage would prevent SMBs from benefiting from the proportionate activity specific regulation of activities involving an interaction with UK financial markets. The DAR will allow SMBs to continue to engage with UK financial markets without being subject to disproportionately burdensome regulation.

2.184 It would also create a two tier system in UK regulation, with some firms subject to requirements in retained EU law, and some subject to the new requirements. This

would be complex to manage, and create cliff-edges for SMBs when they grow. As the government expects the new requirements to better tailored to UK markets, exempting SMBs would prevent them from experiencing the expected benefits.

2.185 At the point of HM Treasury exercising the powers conferred on it by this measure in secondary legislation, the department commits to consider whether it is appropriate to exempt SMBs from specific measures, for example whether it is appropriate to exempt SMBs from direct regulatory requirements made to replace repealed retained EU law. The government is content that the financial services regulators will also consider whether the impact their decisions is proportionate on the SMBs they regulate. More information on the processes the regulators follow when considering these impacts is included in the introduction to this impact assessment.

Could the impact on small and microbusinesses be mitigated while achieving the policy objectives?

2.186 This measure will not directly impact SMBs at the point of Royal Assent. As such there is no need for mitigations at this stage.

2.187 Appropriate mitigations may be considered for SMBs, such as introducing a longer transitional period to mitigate the familiarisation costs associated with changing regulation, during the development of subsequent secondary regulation, and in regulator rules.

## FRF Review: Objectives & Principles

**Problem Under Consideration**

2.188 Following the implementation of the FRF Review, the PRA and the FCA will take on responsibility for setting the requirements on firms which are currently set out in retained EU law. It is therefore necessary to consider whether the regulators' current objectives and regulatory principles contained in FSMA are appropriate, given this expanded responsibility, and reflect the UK's position outside the EU.

2.189 FSMA sets objectives for the PRA and the FCA and requires them to act in a way that advances their objectives when carrying out their general functions. This determines what the regulators must seek to advance when they make rules, set technical standards, and issue guidance.

2.190 The FCA's strategic objective is to ensure that the relevant markets function well. Its operational objectives are to secure an appropriate degree of protection for consumers, protect and enhance the integrity of the UK financial system, and to promote effective competition in the interests of consumers.

2.191 The PRA's general objective is promoting the safety and soundness of PRA authorised persons; it also has an insurance-specific objective of contributing to the securing of an appropriate degree of protection for those who are, or may become, policyholders. The PRA also has a secondary objective to facilitate effective competition in the markets for services provided by PRA authorised persons in carrying on regulated activities.

2.192 The FSMA regulatory principles aim to promote regulatory good practice across the range of the regulators' policymaking. The regulators must take into account eight regulatory principles when discharging their functions, which are:

a. Efficiency and economy - the need to use the resources of each regulator in the most efficient and economic way

b. Proportionality - the principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction

c. Sustainable growth - the desirability of sustainable growth in the economy of the UK in the medium or long term

d. Consumer responsibility - the general principle that consumers should take responsibility for their decisions

e. Senior management responsibility - the principle that a regulated firm's senior management is responsible for ensuring that its business complies with regulatory requirements imposed by or under FSMA, including those affecting consumers

f. Recognising differences in business - the desirability where appropriate of each regulator exercising its functions in a way that recognises differences in

the nature of, and objectives of, different businesses subject to requirements imposed by or under FSMA

g. Openness and disclosure - the desirability in appropriate cases of each regulator publishing information relating to persons on whom requirements are imposed by or under FSMA, or requiring such persons to publish information, as a means of contributing to the advancement by each regulator of its objectives

h. Transparency - the principle that the regulators should exercise their functions as transparently as possible

2.193 When the UK was a member of the EU, Ministers and MEPs could ensure that important, wider public policy priorities were reflected in the rules that apply to firms through the process of negotiating and drafting detailed EU regulations. Following the implementation of the FRF Review, the regulators will be responsible for making rules in areas of retained EU law. When doing so, the PRA will be required to act in way that advances its objectives and the FCA must act in a way that is compatible with its strategic objective and advances one or more of its operational objectives under FSMA. The government and Parliament will not have a formal role in the development of individual rules and therefore will not have an opportunity to ensure public policy priorities are advanced through the rulemaking process.

2.194 In response to the October 2020 consultation on the FRF Review, many respondents shared their views on having a greater focus on competitiveness within the regulatory framework. Those in favour of a competitiveness objective or principle argued that a greater focus on competitiveness as part of the regulatory framework was necessary to support the ability of the UK financial services sector to compete internationally and continue to contribute to the UK's economic prosperity. In response, the government's November 2021 consultation proposed a secondary long-term growth and international competitiveness objective for the PRA and FCA. Respondents to that consultation broadly welcomed it as striking the right balance between ensuring these matters are advanced, without compromising financial stability or the UK's commitment to high regulatory standards.

2.195 Respondents to the October 2020 consultation also noted the need for financial services to play a role in mitigating the effects of climate change. Some advocated for an objective, while others advocated for a regulatory principle, which would require the regulators to have regard to the government's net zero target when making rules. In response, the government proposed to require the regulators to have regard to the government's commitment to achieve a net zero economy by 2050 as set out in section 1 of the Climate Change Act 2008 by including a reference to this commitment in the regulatory principles. The proposal received significant, widespread support from respondents to the November 2021 consultation.

**Rationale for Intervention**

2.196 Following the implementation of the FRF Review, the regulators will be responsible for making rules in areas of retained EU law. The government and Parliament will not have a formal role in the development of individual rules within that framework, and therefore will generally not have an opportunity to ensure public policy priorities are advanced through the rulemaking process.

2.197 When discharging their functions, the regulators will do so according to the objectives and regulatory principles set out in legislation. Regulators will only consider factors specified in legislation or in HM Treasury's recommendations letters to the PRA and the FCA.

2.198 The government considers that the current objectives set broadly the right strategic considerations, and has carefully considered the many representations it has received on this issue, as well as the ongoing public debate. The policy aims encapsulated by the current regulatory objectives are vital to ensuring a stable and fair financial system in which the UK public and international stakeholders can have confidence. Responses to the October 2020 consultation demonstrated that the majority of stakeholders recognise the importance of these objectives to the UK's financial services sector.

2.199 However, the government recognises that the financial services sector is not just an industry in its own right but an engine of growth for the wider economy. As set out in the strategy document published alongside the Chancellor's 2021 Mansion House speech, almost everyone in the UK interacts with financial services on a daily basis – from small events, like everyday purchases using a debit or credit card, to big life-changing events, like taking out a mortgage to buy a new home. The financial services sector enables consumers to save for their retirement, to take out a loan to buy a new car, to insure those things that matter to them most, to access financial advice and guidance when they need it and to keep their money safe and secure in a current account. It allows British businesses to thrive, to manage their cash flow during good times and bad, to invest in order to increase productivity, to manage risk during periods of uncertainty and to create jobs in the UK and abroad. Given its reach, and its importance in helping both businesses and consumers through the ups and downs of their lives, it is vital that the financial services industry supports everyone, and ensures that people can access financial services regardless of their income or background.

2.200 Over recent years, there has been significant debate in Parliament and among industry stakeholders about whether the regulators should have a specific objective to require them to advance the growth of the UK economy and the competitiveness of the financial sector. Respondents to the two FRF Review consultations argued that, given the importance of a thriving financial services sector for UK economic growth and prosperity, the regulators should have a statutory duty to support the economic viability of financial services and the ability of the sector to compete internationally.

2.201 Comparable jurisdictions have various mechanisms that seek to balance regulator objectives for financial stability and consumer protection with objectives related to

growth or competitiveness. As noted by Lord Hill in the UK Listing Review13 other financial services regulators – for example in Australia, Singapore, Hong Kong, and Japan – have growth or competitiveness embedded in their frameworks.

2.202 As the regulators take on responsibility for setting detailed rules in areas currently covered by retained EU law, the government considers that it is right that the regulators' objectives reflect the need to support the long-term growth and international competitiveness of the UK economy, including the financial services sector.

2.203 The government is also committed to tackling climate change and has made a series of commitments to advance environmental and climate goals. In 2019, the UK became the first major economy to write into law its commitment to reach net zero greenhouse gas emissions by 2050. In 2021 the government went further, setting out the world's most ambitious climate change target to cut emissions by 78% by 2035. The financial services sector needs to support these challenging targets if they are to be met.

2.204 The UK's approach to embedding climate considerations within the actions of its financial services regulators is already world leading, with HM Treasury's recommendation letters in March 2021 including the 'transition to an environmentally sustainable and resilient net zero economy' and the new requirement of the PRA and FCA to 'have regard' to the 2050 net zero target when making rules in a number of specific areas legislated for in the FS Act 2021.

2.205 However, the debate in Parliament during the passage of the Act, and respondents to the October 2020 FRF review consultation noted the specific need for new regulatory objectives or a principle relating to green or climate change issues. The government considers there to be an opportunity to further strengthen the UK's regulatory regime relating to climate. Including this in legislation ensures that the commitment to reach net zero is permanently embedded in regulators' considerations going forward.

**Policy Objective**

2.206 The objective is to ensure that, having left the EU, the framework of objectives and principles that guide the regulators' actions, particularly given their additional rule-making responsibilities, continues to set the right strategic considerations.

2.207 The government considers that the regulators' existing objectives set broadly the right strategic considerations and wants to maintain the regulators' focus on these objectives.

2.208 As set out in the strategy document published alongside the Chancellor's Mansion House speech in July 2021, the UK will continue to remain a global leader in promoting high international standards. Alongside this commitment, the government stated its intention to ensure that the financial services sector is delivering for businesses and consumers across the UK. The government considers

[13] 13 *UK Listing Review*, Lord Hill, March 2021

that the regulators' current objectives are each important in helping to deliver these outcomes. Robust regulatory standards encouraged by these objectives are the cornerstone of the UK market's attractiveness, and the stability and soundness of the UK's market remains an important priority for the government.

2.209 The government wants to give the regulators a legal basis for advancing long-term growth and international competitiveness that does not detract from their existing objectives of ensuring that UK firms remain safe and sound, that the UK's markets function well, that there is healthy competition in the interests of consumers, and that consumers and users of financial services receive an appropriate degree of protection.

2.210 The government also wants to embed consideration of the UK's statutory climate target across the full breadth regulators' rulemaking and put this on a permanent footing, supporting the ambition to make the UK a net zero aligned financial centre. A green regulatory principle will cement the government's long-term commitment to transform the economy in line with its Net Zero target and vision to make the UK a net zero financial centre by ensuring the regulators must have regard to these considerations when discharging their functions.

**Description of options considered**

2.211 Option 0 (Do Nothing) – If no action is taken, the regulation of the UK's financial services sector will continue in its current form: a mixture of FSMA regulation, and the EU regulation which was in place at the point of leaving the EU.

2.212 As explained above, while this retained EU law remains in place, the expert regulators are not properly able to carry out the role that Parliament has given them under FSMA and regulate such activities in a way which furthers their statutory objectives, and which is tailored to UK markets and consumers.

2.213 Most rule changes would need to be made by the government via primary legislation, rather than the regulators being able to adapt their rules as they can under the FSMA model. This would place inappropriate and substantial resource pressures on Parliament.

2.214 Option 1 (Preferred Option) – To repeal retained EU law relating to financial services and reform the objectives and regulatory principles of the PRA and FCA.

2.215 As set out under the FRF Review: Repeal of retained EU law measure above, the government intends to repeal all retained EU relating to financial services.

2.216 When the government commences the repeal of retained EU law legislated for in this Bill in full, the regulators will take on greater regulatory responsibility for areas currently regulated by retained EU law. It will also be necessary to ensure the regulators statutory objectives and principles, which guide their regulatory action, are appropriate given this increased responsibility and reflect the UK's position outside the EU.

2.217 This Bill will introduce new secondary objectives to provide greater focus on long-term growth and international competitiveness. To reflect the importance of the

high standards that underpin the UK's regime and to maintain confidence in the safety and stability of the UK's market, the new growth and competitiveness objectives will be secondary to the FCA's strategic and operational objectives and the PRA's general and insurance objectives. This approach was broadly supported by respondents to the November 2021 consultation.

2.218 The Bill will also require the regulators to have regard to the government's commitment to achieve a net zero economy by 2050 as set out in section 1 of the Climate Change Act 2008 by including a reference to this commitment in the regulatory principles. The proposal received significant support from respondents to the November 2021 consultation.

2.219 If this action is not taken following the repeal of retained EU law, the regulators will make rules as part of the discharge of their functions, including on areas previously in retained EU law, acting in a way that advances their existing objectives and having regard to current regulatory principles.

2.220 In areas that were previously in retained EU law, this will mean that less consideration is given to important public policy priorities than would have been the case during the EU legislative process.

2.221 The regulators will not have the appropriate statutory basis to act to advance long-term growth and international competitiveness.

2.222 There will be no legislative requirement to have regard to the net zero target across the regulators' full responsibilities.

2.223 Other Options (Non-preferred) - In response to the October 2020 and November 2021 consultations, the government received a number of alternative proposals for consideration. The government's response to the November 2021 consultation was published on 20 July 2022, alongside the Bill.

2.224 Respondents to both consultations suggested that the competitiveness objective should be primary, sitting alongside the FCA's operational objectives and the PRA's general objective. The government considers that making this objective secondary provides the regulators with a clear prioritisation of their objectives, and so strikes the right balance between providing a new focus on advancing long term growth and competitiveness while maintaining the regulators focus on their existing objectives.

2.225 Some respondents to the October 2020 consultation suggested that an alternative method for increasing the regulators' focus on competitiveness would be the introduction of a new regulatory principle focused on competitiveness. However, the regulators are not required to act to advance their regulatory principles; instead, they must take them into account when pursuing their statutory objectives. While a regulatory principle would likely have some effect in increasing the regulators' focus on competitiveness, the government considers that it would not provide the regulators with the appropriate statutory basis required to act to support competitiveness in line with the government's vision for the sector.

2.226 Some respondents proposed that the net zero target should be an objective instead of a principle. The net zero target, as a wider government policy with a specific goal

where many of the levers sit outside financial service regulation, is more appropriately progressed by the regulators as a regulatory principle, and therefore considered when advancing the regulators' objectives.

**Outline of preferred policy**

2.227 The preferred policy is to add to the regulators' objectives to improve their effectiveness in contributing to the UK's long-term economic growth and international competitiveness.

2.228 The Bill introduces new objectives for growth and competitiveness for the regulators. These objectives will be secondary to the FCA's strategic and operational objectives and the PRA's general and insurance objectives. The new objectives will require the PRA and the FCA to act in a way that, subject to aligning with international standards and so far as is reasonably possible, facilitates the long-term growth and international competitiveness of the UK economy, including the financial services sector. As with the PRA's current competition objective, this would not require or authorise the FCA or the PRA to take any action inconsistent with their existing objectives.

2.229 Through the regulatory principles, the Bill will ensure that the regulators must take into account the government's net zero target when making rules. This will place on a permanent footing the recommendation to have regard to the target that was first given in HM Treasury's recommendations letters of March 2021. The PSR's sustainable growth principle will be maintained, and the climate change target incorporated into this.

**Methodology**

2.230 As set out above, the changes that will be delivered as the outcomes of the FRF Review are to the overall framework and will therefore be for the regulators to implement. As such, the costs and benefits of operationalising these measures will be determined by the PRA and the FCA.

2.231 It is not possible to quantify the effect of these changes to the regulators' objectives and regulatory principles, as it would require HM Treasury to make judgements on how each regulator will embed and operationalise the objective and changes to the regulatory principles, balance this with its other objectives, and the effect these decisions will have on the regulators' rulemaking.

2.232 Any attempt by the government to estimate the impact would also not be consistent with the principle of operationally independent regulators embedded in FSMA.

2.233 As explained in the introduction of this impact assessment, HM Treasury is content the regulators will have in place appropriate mechanisms to consider the impact of their decisions.

2.234 More information on the FCA and PRA's approach to assessing costs and benefits, including how that will be bolstered by measures in this Bill can be found in the introduction to this impact assessment under Approach to small and micro business assessment.

**Policy Costs**

2.235 As set out above, the changes proposed through the FRF Review are to the UK's domestic framework for financial services regulation, and so the legislation does not impose an immediate cost to firms.

2.236 The government expects the new objectives to impact the way that the regulators make rules, but the nature of the impact will be a decision for the regulators and it is not possible or appropriate for the government to pre-judge these decisions, or to attempt to quantify such an impact.

2.237 However, it is expected that the regulators will make changes to their rules to advance the new objectives – particularly when they make the rules to replace the regulatory requirements in retained EU law that are repealed by the Bill. This may involve some familiarisation and transitional costs for businesses (such as changing their IT systems or process to reflect the change).

2.238 Rules made with consideration for net zero may also create new regulatory requirements for firms. However, the government expects such costs will be offset by the longer-term benefits outlined below.

**Policy Benefits**

2.239 The government expects that the proposed secondary long-term growth and competitiveness objective will enable the PRA and the FCA to make rule changes to advance the long-term growth and competitiveness of the UK economy, including the Financial Services sector. As set out in the November 2021 consultation document, this will be done in a way that respects the need for the regulators to maintain high regulatory standards in the UK, align with international standards and act in a way that is consistent with their existing objectives. Respondents to the November 2021 consultation noted that this new objective would support the UK's vision for an open and competitive financial services sector, and would promote regulatory efficiency.

2.240 As set out above, the implementation of the objectives and principles is for the regulators so it is not appropriate for the government to speculate on exactly what benefits will result from the change, or to attempt to quantify those. However, the government expects that there will be a step—change in the regulators approach, similar to the introduction of the PRA's secondary competition objective in 2014. The introduction of this secondary competition objective led to a number of policies to facilitate effective competition including to make the calculation of regulatory capital requirements fairer in retail banking, levelling the playing field and reducing barriers to entry. This had led to the authorisation of 30 new UK banks over 9 years. The PRA has also indicated its ambition to go further to ensure a proportionate regime and promote competition now that the UK has left the EU via their Strong & Simple initiative for smaller banks and building societies.

2.241 The new growth and competitiveness objectives should therefore lead to more effective and proportionate regulation for firms, benefitting the firms that operate in those markets and the consumers that are served by them. It is expected to ensure that the regulators are supporting the government's vision for a financial services

sector that is globally competitive and acts in the interests of communities and citizens.

2.242 For the regulatory principles, the government expects that a regulator required to have regard to the commitments in the Climate Change Act would make rules that more actively favour investment that is consistent with the government's net zero target.

2.243 By providing benefits for green industries, this will ultimately benefit consumers through a more environmentally sustainable economy.

2.244 Through the FS Act 21, the PRA and the FCA were given 'have regards' in relation to the net zero target and competitiveness14. These 'have regards' shaped the policy decisions made by the PRA and the FCA, particularly in response to stakeholder feedback to deliver more effective regulation.

2.245 The specific benefits of the new objectives and changes to the regulatory principles will manifest in the longer term, as rules are introduced under the new framework rather than the existing one.

**Assumptions, limitations, and considerations**

2.246 In general terms, HM Treasury considers that a long-term growth and international competitiveness objective would lead to increased long-term growth and competitiveness for the UK economy and financial sector, and this has been supported by responses to the consultations on the FRF Review.

2.247 Similarly, consultation responses have noted the likely impact of embedding the net zero target in the regulatory principles, benefitting consumers and industry through a more environmentally sustainable economy.

**Small and MicroBusiness Assessment (SaMBA)**

Number and distribution of businesses in scope of the regulation

2.248 This measure does not directly impact any small or microbusinesses.

2.249 At this stage it is not possible to accurately quantify the number of SMBs who will be impacted by the exercise of these powers. To attempt to accurately estimate the number of small and microbusinesses impacted at the stage of secondary legislation would require HM Treasury to pre-judge policy decisions to be made in future by HM Treasury and by the independent financial services regulators. Any estimate given through such an enterprise would likely be inaccurate and out of date by the time the impact is felt by SMBs due to future, as yet unknown, policy decisions and potential unexpected changes in the UK's financial services markets. Many of the decisions will be subject to consultation before decisions are made.

2.250 As set out above, this is a framework measure that will enable the financial services regulators to set the direct regulatory requirements that apply to firms. The

[14] Specifically, the "relative standing of the United Kingdom as a place for internationally active investment firms to be based or to carry on activities"

regulators regulate a wide range of financial services firms, some of which are small and microbusinesses.

2.251 According to data provided by the PRA, the PRA currently regulate 1432 financial services firms, including 409 Credit Unions, 371 Capital Requirements Regulation (CRR) firms and 652 insurers. All 409 Credit Unions (100 per cent) can be classified as SMBs (firms with less than 50 employees). The PRA did not have data on employee size for all CCR and insurance firms. However, using a threshold of turnover of less than £10.2 million the PRA estimate 25 CRR firms are SMBs[15] (6.74 per cent) and at least 328 insurers are SMBs (50.3 per cent)[16]. The government anticipates that these SMBs may be indirectly impacted by this measure in future, where this measure leads to changes in PRA rules.

2.252 Similarly, the FCA currently regulates over 50,000 firms. The FCA does not hold comprehensive data on the number of employees in these firms. Not all FCA regulated firms are required to report data to the FCA, and so only 38,599 out of the 50,000 firms regulated by the FCA have submitted turnover data for the 2021 financial end. Out of these 38,599 reporting firms, 34,533 (89%) can be classified as 'small' (turnover of less than or equal to £10.2 million). This data is based on the 2021 financial end for FCA regulated firms with an active status and where the data is stored and accessible from the FCA's data lake. It does not cover data reported by firms who no longer have an active status. Where there are gaps, the FCA have looked to try to fill these using information from a survey conducted in response to the COVID-19 situation, though it should be noted that not all firms completed this. Using 89% as a proxy, HM Treasury estimates that approximately 44,500 SMBs are currently regulated by the FCA.

2.253 It is worth noting that some of these financial services firms will have significant revenues despite being small in terms of the number of employees and may therefore not be disproportionately indirectly impacted as a result of this measure.

Do the impacts fall disproportionately on small and microbusinesses?

2.254 As explained above, it has not been possible to accurately quantify businesses within scope of this measure at this stage. For similar reasons it is not possible to quantify the costs and benefits to businesses of this measure and what proportion of these will fall on SMBs.

2.255 The impact will ultimately depend on how the financial services regulators choose to advance their new objectives and have regard to their new principle. However, the fact that this legislation will lead to the creation of a more agile and flexible

[15] This excludes UK incorporated banks which are part of a wider banking group.

[16] The PRA does not hold data on turnover amount for firms in the Temporary Permissions Regime (TPR) , firms in Supervised Run-Off (SRO), or for Gibraltar authorised insurers and did not provide an estimate of how many of these firms are SMBs.

framework is highly likely to benefit small and microbusinesses as the regulators will be able to easily respond to market changes and adapt rules where necessary.

2.256 When carrying out their functions, regulators are required by statute to have regard to their regulatory principles. One of these is the proportionality principle; the principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction.

2.257 More information on the FCA and PRA's approach to assessing costs and benefits to business, including how that will be bolstered by measures in this Bill can be found in the introduction of this impact assessment under Approach to small and microbusiness assessment.

*Qualitative assessment of potential future costs and benefits on SMBs*

2.258 Although the government is unable to give an accurate quantitative assessment of future costs and benefits of this measure on SMBs at this stage given the various unknowns, the government has included the following qualitative assessment of how the potential expected costs and benefits for SMBs arising from the exercise of the powers in this measure in future.

*Benefits to SMBs*

2.259 As the measures relating to the FRF Review are designed to deliver a framework for the future, benefits to all businesses including SMBs will be ongoing rather than one-off.

2.260 The regulators advance their objectives when carrying out their general functions. When making and enforcing regulation, the regulators will need to consider international competitiveness and the growth of the UK economy in the medium-long term. Therefore, this should create a regulatory environment conducive to the growth and innovation of all SMBs, including those outside of the of the financial services sector.

*Costs to SMBs*

2.261 It is expected that the regulators will make changes to their rules to advance the new objectives – particularly when they make the rules to replace the regulatory requirements in retained EU law that are repealed by the Bill. This may involve some transitional costs for businesses, including SMBs (such as changing their IT systems or process to reflect the change). The government is aware that SMBs may be disproportionally impacted given they are less able to absorb the fixed costs associated with familiarisation. However, the government expects such costs will be offset by the longer-term benefits outlined above.

2.262 Rules made with consideration for net zero may also create new regulatory requirements for SMBs.

2.263 However, the government anticipates overall that the benefits to SMBs of increased growth and competitiveness set out above will outweigh any such costs.

Could small and microbusinesses be exempted while achieving the policy objectives?

2.264 With respect to the provisions in this Bill, exemption would prevent SMBs from benefiting from regulation designed with competitiveness and growth in mind. For example, if a regulator decided to amend its reporting requirements in order to be less burdensome, the regulators would not be able to do so for SMBs, as the regulation of SMBs would be exempt from the objective to advance competitiveness.

2.265 Exempting SMBs from regulations made to advance the objectives, or with consideration of the net zero emissions target, and their possible effects would also require the FCA and the PRA to have an entirely different process and set of rules for SMBs, which would be highly duplicative. Therefore, it would not be appropriate to exempt SMBs.

2.266 The existing framework for regulation governs whether or not SMBs are included within the scope of the regulators' rulemaking powers and supervision, and the new objectives and principles are an amendment to this framework. SMBs inclusion in the scope of regulator rules and authorisation is determined by the activities they undertake. Within the scope afforded to them by the framework, the regulators will also be able to make decisions on whether it is appropriate, and in line with their duties, to exempt SMBs from rules made or amended on the basis of these amendments to the framework.

Could the impact on small and microbusinesses be mitigated while achieving the policy objectives?

2.267 It is not appropriate to lessen the impacts of the new objectives and principle on SMBs and the measure does not directly impact SMBs at the point of Royal Assent. As the regulators consider any changes to their rules as a result of their new objectives, at that point appropriate mitigations may be considered for SMBs. This could include, for example, consideration of a longer transitional period to mitigate the familiarisation costs associated with changing regulation. The government is content that the financial services regulators will consider the impact of their rules on the SMBs they regulate. More information on the processes the regulators follow when considering these impacts is included in the introduction to this impact assessment under Approach to small and micro business assessment.

Wider impacts on small and microbusinesses.

2.268 This legislation will lead to the creation of a more agile and flexible framework, with an increased focus on growth and competitiveness.

2.269 More effective and agile financial services regulation will benefit SMBs in the wider UK economy, for example, as FS firms will be better and more safely able to provide credit, including to SMBs. This in turn should increase innovation and investment in the UK economy.

## FRF Review: Accountability and Stakeholder Engagement

**Problem Under Consideration**

2.270 Repealing retained EU law in order to move to a comprehensive FSMA model of regulation, where the expert independent regulators generally set the regulatory requirements which apply to firms in their rulebooks, will give the regulators significant new rulemaking responsibilities.

2.271 Given these new responsibilities, it is important that both the mechanisms by which Parliament holds the regulators to account, and the mechanisms underpinning the regulators' relationship with HM Treasury are strengthened. This will ensure there continues to be appropriate democratic input into, and public oversight of, the regulators activities.

2.272 Given the breadth of the regulators' responsibilities, it is also vital that there are opportunities for consumers, relevant stakeholders and firms to engage with and scrutinise the development of regulatory proposals. Any policymaking process is likely to be more effective if it draws sufficiently on the views, experience and expertise of those who may be impacted by regulation.

2.273 There are already substantial provisions in the UK's domestic framework for Parliament and HM Treasury to hold the regulators to account, and for stakeholders to engage in the regulators' policymaking process is established in FSMA.

Accountability to Parliament

2.274 As Parliament sets the regulators' objectives and gives them the powers to pursue those objectives, Parliament rightly has a unique and special role in relation to the scrutiny and oversight of the financial services regulators.

2.275 The system of Parliamentary select committees is particularly important in financial services policy and in relation to the scrutiny of the work of the regulators. Relevant select committees, and HM Treasury Select Committee (TSC) in particular, provide scrutiny of financial services policy in the following ways:

a. Select committee inquiries – Committees choose their own subjects of inquiry and decide the duration and approach that will be used for each inquiry. The committees have the power to send for "persons, papers and records" which they decide will be relevant. Other committees, such as the former House of Lords EU Financial Affairs Sub Committee and the House of Commons European Scrutiny Committee, have also played a key role in scrutinising financial services policy.

b. Regular hearings to scrutinise the work of the financial services regulators – the TSC routinely examines the regulators' approach to policy and administration.

c. Pre-commencement hearings – Parliament, through the TSC, conducts pre-commencement hearings following the appointment of the Chief Executive of the FCA

2.276 There are also long-established scrutiny arrangements in place for Parliament to hold Ministers of the Crown accountable for the work of HM Treasury and the UK's financial services regulators. These arrangements include:

a. Government Ministers regularly respond to oral and written questions in both Houses of Parliament.

b. Government policy is scrutinised through a range of Parliamentary debates.

c. Government legislation is debated and scrutinised according to the procedures for primary and secondary legislation.

2.277 Both Houses of Parliament are kept informed of policy and regulatory initiatives through the making of ministerial statements and by the laying of important documents before Parliament, including the annual reports of the financial services regulators.

Relationship with HM Treasury

2.278 HM Treasury ministers have overall responsibility for the UK's financial services regulatory framework and the continued effective operation of the financial services regulators as part of that framework. HM Treasury ministers can therefore be regarded as having a constitutional duty to ensure the regulators operate effectively and in accordance with framework.

2.279 Existing domestic legislation already provides a number of formal accountability mechanisms between the regulators and HM Treasury in specific circumstances, including:

a. HM Treasury appoints the Chair and Chief Executive of the FCA, as well as members of the FCA board and Prudential Regulation Committee (the governing committee of the PRA).

b. HM Treasury may appoint an independent person to conduct a review of the economy, efficiency and effectiveness of the FCA's use of resources.

c. HM Treasury may direct the PRA or FCA to carry out investigations into specific events if that is in the public interest (under section 77 of the Financial Services Act 2012).

d. HM Treasury may direct the PRA or FCA to take action, or refrain from taking action, in relation to specified matters in order to ensure that the UK meets its international obligations.

2.280 In addition, FSMA provides HM Treasury with the ability to make recommendations to the regulators through open 'recommendations letters' on issues related to matters of economic policy which the regulators should take into account when discharging certain statutory duties. The most recent recommendations for both the PRA and FCA were issued on 23 March 2021 supplemented by a further update issued on 7 April 2022.

Stakeholder Engagement

2.281 Engagement with stakeholders is embedded in the regulators' policymaking process through the application of statutory requirements and public law principles. The PRA and the FCA are subject to statutory requirements in FSMA which, in general, require them to consult with the public on rule proposals. These PRA and FCA consultations are generally open for three months, though this can change depending on the issue – for example, in case of emergency, consultations can be avoided or run for significantly shorter periods.

2.282 As part of these consultation requirements, the PRA and the FCA must explain why making the proposed rules advances and is compatible with their objectives as set by Parliament in legislation. The regulators must also explain how the proposals are compatible with their obligation to take into account the regulatory principles. They must also produce a cost-benefit analysis (CBA) of the draft rules.

2.283 In addition to the duty to consult publicly on proposals, the FCA has a general duty to "make and maintain effective arrangements for consulting practitioners and consumers." The PRA has a similar general duty to "make and maintain effective arrangements for consulting PRA-authorised persons or, where appropriate, persons appearing to the PRA to represent the interests of such persons", on the extent to which the PRA's general policies and practices are consistent with its general duties. As part of these duties, the regulators are required to maintain stakeholder panels.

2.284 The regulators have regular meetings and discussions with their panels, in which most major policy and regulatory proposals are presented for comment at an early stage. The panels' contributions to policy development as part of this process are confidential to ensure both the regulator and panel members can share ideas and feedback openly. This confidentiality allows the regulators to engage the panels when policy is in the early stages of development ahead of public consultation.

2.285 Greater rule-making responsibilities will increase the opportunities for the regulators to consult their statutory panels from the outset of policy and regulatory development, which was not possible to the same extent while the UK was a member of the EU. The government and the regulators consider this will strengthen the panels' important ability to provide stakeholder input into the development of policy and regulation.

Accountability after EU Exit

2.286 When the UK was a member of the EU, the government, through ministerial engagement and MEPs in the European Parliament, had a formal role in the EU system of regulatory policymaking. Having left the EU, the regulators will have greater responsibility to set the regulatory requirements which apply to firms in areas previously covered by retained EU law. If there are no changes to the UK's domestic arrangements for holding the regulators to account and mechanisms for stakeholders to engage in regulatory policymaking, there would be less democratic input and public oversight of rulemaking in areas previously covered by retained EU law than was the case when these rules were made by the EU.

2.287 Respondents to both consultations on the FRF Review supported enhancements to the mechanisms by which Parliament hold the regulators to account, and the mechanisms underpinning the regulators' relationship with HM Treasury to ensure there continues to be appropriate democratic input into, and public oversight of, the regulators' activities.

2.288 Respondents also supported strengthening and enhancing the arrangements for stakeholders to engage in the regulators' policymaking to ensure that the views, experience, and expertise of those impacted by regulation continue to be effectively drawn on as the regulators' responsibilities expand.

2.289 The Payment Systems Regulator (PSR) is the economic regulator responsible for overseeing payments systems. The PSR was initially out of scope of the FRF Review, pending a specific government consultation on payments published in July 2022. However, in light of stakeholder feedback, and recognising that the PSR will assume responsibility for some areas of retained EU law, HM Treasury has considered that it would be more consistent to apply the FRF Review accountability mechanisms to the PSR through this Bill.

2.290 The measures set out below should lead to more effective stakeholder engagement by the regulators and scrutiny by Parliament and government. This should result in more efficient and effective rules and requirements for financial services firms regulated and supervised by the PRA and the FCA; this also includes benefits to consumers.

**Rationale for Intervention**

2.291 Enabling the regulators to set the regulatory requirements in areas that are currently set in retained EU law, with no changes to their accountability and stakeholder engagement mechanisms, would result in insufficient democratic input and public oversight for regulatory rulemaking.

2.292 EU legislation was proposed by the European Commission and negotiated with Member State governments and the European Parliament. HM Treasury, which led the UK's negotiations on EU financial services legislation, therefore took on responsibility for key areas of regulatory policy.

2.293 While the UK regulators supported HM Treasury on the technical detail, the government was directly responsible for negotiating areas of detailed regulatory requirements that would otherwise have sat with UK regulators under the FSMA model. This allowed ministers to reflect wider public policy considerations in the UK's approach to negotiations; for example, ensuring proposals on the regulation of mortgages didn't adversely affect the ability for borrowers to attain home ownership in the UK.

Accountability to Parliament

2.294 Respondents to the FRF Review consultations overwhelmingly agreed that the role of Parliament is vital for the effective scrutiny of the regulators, and there was broad support for the existing mechanisms for Parliament to hold the regulators and HM Treasury to account.

2.295 Respondents felt that the current approach to scrutiny via select committees is appropriate and effective. Respondents noted that the Treasury Select Committee (TSC) is well-established, well-regarded, and that its scrutiny of the regulators through its reviews and inquiries has been effective.

2.296 Throughout the passage of the FS Act 2021, several parliamentarians commented that the current legislation does not set specific requirements on regulators to provide Parliament with the information it requires to scrutinise financial services policy effectively. They called for an explicit requirement for the regulators to provide Parliament with relevant information, tabling amendments to this effect. The government recognised these concerns, and welcomed the commitments from the PRA and the FCA in March 2021 to an open and transparent relationship with Parliament, and the reassurance that the PRA and the FCA would have due regard to the conclusions of any Parliamentary scrutiny.

2.297 Given the support for the existing mechanisms, the government wants to formalise the current processes so that they endure and ensure that Parliament retains access to the information it needs to undertake its scrutiny.

The relationship with HM Treasury

2.298 The government considers that the existing mechanisms governing the regulators' relationship with HM Treasury are largely effective. This was supported by the responses to both consultations, which found that the split of responsibilities between Parliament, regulators and HM Treasury was broadly right. However, the government considers that the greater responsibility for the regulators should be balanced with effective policy input and appropriate accountability to government. This view is supported by responses to the FRF Review consultations.

2.299 The government considers that the specific area of regulators' responsibilities where the relationship with HM Treasury requires strengthening is rulemaking, as this is the area where the regulators' responsibilities are expanding following EU exit.

2.300 This was supported by responses to the November 2021 consultation, which generally supported the proposals for increased accountability to HM Treasury.

2.301 The regulators' other functions, including enforcement and supervision, are not increasing as a result of leaving the EU and they are not areas in which increased accountability to HM Treasury would be appropriate or desirable.

Stakeholder engagement

2.302 The government considers that the existing primary method for stakeholders to engage in the regulators' policymaking process, the regulators' requirement to consult publicly on their draft rules, remains the key mechanism for this engagement.

2.303 Respondents to the October 2020 FRF Review consultation noted that the regulators already conduct extensive stakeholder engagement and research on their proposed policies, and that the consultation requirement works well. Suggestions for improvements tended to be related to strengthening and enhancing these practices and the statutory underpinning, rather than an overhaul of the consultation process.

2.304 The government recognised that some respondents to consultation raised concerns about specific aspects of the regulators' stakeholder engagement. This included concerns about aspects of the operation of the regulators' statutory panels, a lack of clarity on the regulators' approach to reviewing their rules, and the rigour, scope, and external challenge of the regulators' cost-benefit analysis (CBA). The FRF Review proposals are intended to reflect existing best practice by the regulators while addressing these concerns.

2.305 Respondents to the November 2021 consultation generally welcomed the proposals on stakeholder engagement, though some noted that the proposals could have gone further by, for example, providing the CBA Panel with a 'sign-off' role for CBA or creating a mechanism for stakeholders to trigger a rule review.

**Policy Objective**

2.306 The policy objective is to ensure that:

a. Parliament has the appropriate tools to conduct scrutiny of regulators' rulemaking and other functions in the manner that Parliament best sees fit.

b. The greater responsibility for the regulators is balanced with effective policy input and appropriate accountability to HM Treasury.

c. There is appropriate transparency of regulators' operations for stakeholders to be confident in them.

d. There is appropriate systematisation of important practices, such as CBA and rule review.

**Description of options considered**

2.307 Option 0 (Do Nothing) - As set out in the FRF Review: Repeal of retained EU law section of this impact assessment, if no action is taken, the regulation of the UK's financial services sector will continue in its current form: a mixture of FSMA regulation, and the EU regulation which was in place at the point of leaving the EU.

2.308 As explained above, while this retained EU law remains in place, the expert regulators are not properly able to carry out the role that Parliament has given them under FSMA and regulate such activities in a way which furthers their statutory objectives, and which is tailored to UK markets and consumers.

2.309 Most rule changes would need to be made by the government via primary legislation, rather than the regulators being able to adapt their rules as they can under the FSMA model. This would place inappropriate and substantial resource pressures on Parliament.

2.310 Option 1 (Preferred Option) – Repeal retained EU law and introduce enhancements to requirements on the financial services regulators for democratic oversight and stakeholder consultation.

2.311 As set out under the FRF Review: Repeal of retained EU law measure above, the government intends to repeal all retained EU relating to financial services.

2.312 When the government commences the repeal of retained EU law legislated for in this Bill in full the regulators will take on greater rule-making responsibility for areas currently regulated by retained EU law. If the government was to take no further action then existing provisions on accountability and stakeholder engagement in FSMA would continue to apply to the financial services regulators. However, given the fact that the regulators will take on greater rule-making responsibilities for areas currently covered by retained EU law, these alone would not provide sufficient democratic input and public oversight.

2.313 The increased importance of the panels' roles will not be matched with increased transparency about how members are appointed and when the panels have been consulted.

2.314 Where the regulators undertake some processes voluntarily, for example, bringing consultation papers to the attention of the TSC and reviewing their rules, a lack of legislative underpinning may result in an inconsistent approach across all the regulators' rule-making, which could create uncertainty for stakeholders.

2.315 The preferred option is to introduce a number of additional mechanisms and formalise some existing arrangements to increase democratic input and public oversight of the regulators' policymaking while maintaining the independence of the regulators and the agility of rulemaking. HM Treasury consulted in November 2021 on a number of proposals which respondents to the consultation broadly supported. These proposals sought to:

a. Formalise existing arrangements for Parliamentary accountability to ensure Parliament has the tools it needs to conduct scrutiny.

b. Strengthen the accountability relationship with HM Treasury with targeted additional mechanisms.

c. Ensure transparency and systematisation of important practices through mechanisms relating to the regulators' statutory panels, the production of cost-benefit analysis (CBA), and the regulators' review of rules.

2.316 Respondents to the November 2021 consultation were broadly supportive of these proposals. There was particular interest in the rule review measure, where several respondents agreed with the proposal but sought further clarity on how it would operate in practice.

2.317 Option 2 (Non-preferred) - Alternative proposals arising from the consultation. As noted, the regulators often go beyond the existing accountability and stakeholder engagement requirements set out in legislation. For example, they already regularly bring consultation papers to the attention of the TSC and review their rules.

2.318 An alternative option would be for the regulators to commit to this activity via public statements or Memoranda of Understanding rather than making them legislative requirements. However, this would not necessarily result in a consistent approach across all the regulators' rule-making, and regulators could still choose to change or cease these practices. Legislation would place them on a permanent footing.

2.319 As an example of the uncertainty this causes, throughout the passage of the Financial Services Act 2021, several parliamentarians commented that the current legislation does not set specific requirements on regulators to provide Parliament with the information it requires to scrutinise financial services policy effectively. They called for an explicit requirement for the regulators to provide Parliament with relevant information, tabling amendments to this effect.

2.320 Alternative options for achieving increased stakeholder engagement, Parliamentary scrutiny, and strengthening the relationship with HM Treasury were also suggested by respondents to the October 2020 and November 2021 consultations.

2.321 In the October 2020 consultation, the government suggested some form of general arrangement whereby the regulators would consult HM Treasury more systematically on proposed rule changes at an early stage in the policymaking process and before proposals were published for public consultation. Given the detailed measures proposed, the government does not consider that any further statutory arrangements for how the regulators may be required to consult HM Treasury are necessary.

2.322 Some respondents to both FRF Review consultations recommended the creation of an external body to provide additional independent challenge to the regulators and scrutiny of final rules. Proposals differed on whether this would be a body explicitly supporting the relevant Parliamentary committee, or an entirely stand-alone body. In both cases it was suggested this body could enhance Parliamentary scrutiny of proposals by issuing independent reports at public consultation stage on whether the regulators' proposals are likely to advance their objectives. The practical obstacles to overcome in making such a body operate effectively are substantial, and there would be significant cost and resource burdens. Such a body would also duplicate existing functions and potentially undermine the regulators' operational independence.

2.323 The government considers that the existing avenues for stakeholders to provide input, feedback, and challenge through public consultation, as well as the role of HM Treasury and Parliament in assessing whether the regulators are advancing their objectives, remain the appropriate accountability mechanisms.

2.324 Some respondents to the November 2021 consultation also suggested that the CBA Panel could be given a 'sign-off' role on regulator CBAs. This, however, would undermine the panel's intended role as a 'critical friend', with which the regulators can freely and frankly discuss CBA. It would also risk reducing the regulator's agility.

**Outline of preferred policy**

2.325 The government will introduce additional mechanisms and formalise existing mechanisms to increase democratic input and public oversight.

2.326 In line with the principle of operationally independent regulators, and precedent from similar previous requirements on the regulators in FSMA and other financial services legislation, the requirements in primary legislation will be high-level. This will provide the expert regulators with the flexibility to establish the most effective arrangements for carrying out their new obligations.

2.327 The mechanisms introduced in primary legislation are set out below.

Accountability to Parliament

2.328 A requirement for the regulators to notify the relevant select committee when they publish a consultation. This will include requiring the regulators to draw attention to the section of the consultation dealing with how the proposals advance FCA's operational objectives and the PRA's objectives and how they have considered their regulatory principles and any other relevant recommendations in the recommendation letters from HM Treasury that the regulators must have regard to. This requirement will extend to the PSR.

2.329 A requirement for the regulators to respond to Parliament. This will include requiring the regulators to respond in writing to formal responses to relevant consultations from Parliamentary committees. This requirement will extend to the PSR.

2.330 These measures have been designed to support more effective accountability to, and scrutiny, of the regulators by Parliament. They aim to ensure that select committees continue to have access to the information needed to best scrutinise the work of the regulators and set expectations for how the regulators must respond to any representations from Parliamentary committees.

The relationship with HM Treasury

2.331 A requirement for the regulators to respond annually to the recommendations letters issued by HM Treasury, outlining how they have taken into account the recommendations which HM Treasury will lay before Parliament. This will increase HM Treasury's and wider stakeholders' ability to see how the regulators have taken into account the recommendations. This includes a new requirement for HM Treasury to send recommendations to the PSR, who will also be required to respond annually.

2.332 A power for HM Treasury to require the regulator to review their rules when it is in the public interest. There is currently no formal mechanism for HM Treasury, or anyone else, to require the regulators to conduct reviews of their existing rules. This power will provide for more effective regulation by ensuring there is such a mechanism to ensure the regulator is required to review its rules where HM Treasury considers it is in the public interest. HM Treasury will also be able to require the PSR to review its generally applicable requirements (which are the equivalent to rules for this regulator) where HM Treasury considers it is in the public interest.

Stakeholder engagement

2.333 Placing the Listing Authority Advisory Panel and the PRA Practitioner Panel's insurance sub-committee which are currently maintained voluntarily by the stakeholders on a statutory footing. This will ensure consistency across the

requirement for all panels, provide confidence in the continuance of previously voluntary practices and clarify the minimum requirements for the regulators. In turn, this is expected to provide confidence to stakeholders that the Panels are permanent and that the regulators have a duty to consult with them where appropriate.

2.334 A requirement for the regulators to publish information on their engagement with stakeholder panels (including those of the other regulators) both as part of annual reports, and public consultations on rules. This will increase transparency of regulator operations, improving the ability of Parliament to scrutinise them, and of stakeholders to comment on them.

2.335 A requirement for the regulators to publish a statement of policy on the processes they use to appoint members to their stakeholder panels and to consult HM Treasury before publication. This will increase transparency of regulator operations, improving the ability of Parliament to scrutinise them, and of stakeholders to comment on them, aiding the regulators ongoing work to improve the diversity of panels.

2.336 A requirement for the regulators to each publish and maintain a statement of policy on their conduct of cost-benefit analysis (CBA). This will provide transparency regarding when stakeholders can expect a CBA to be conducted, and what that CBA will consist of, to support robust regulatory policymaking. Clear and publicly available CBA processes should provide further assurance to stakeholders that the regulators are seeking to understand the effect of their regulatory policymaking. This should also support stakeholders in considering effectively whether the regulators' assessments through their CBA are correct.

2.337 A requirement for the regulators to each establish a panel to support the regulators' production and development of CBA. The regulators must consult the panel on production of CBA before public consultation. However there may be instances where it is disproportionate for the regulators to consult with the CBA Panel before publication of a consultation so the regulators will be able to agree criteria with the Panel for when they do not need to be consulted pre-publication. The regulator can also consult the panel after public consultation. The CBA Panel will improve the overall quality of rulemaking by improving the CBA underpinning it. The government also considers that it can increase stakeholders' confidence that there is regular, independent input into the regulators' CBA. The PSR will be required to consult the FCA's CBA panel.

2.338 A requirement for the regulators to keep their rules under review, accompanied by a requirement for the regulators to each publish and maintain a statement of policy for how they will carry out the requirement. The main purpose of the review requirement and statement is to encourage systematisation of regulators' review of rules and provide clarity and transparency for stakeholders on how and when rules are reviewed. This will allow stakeholders to be confident that reviews are happening regularly and in a consistent manner, increasing confidence in regulation. More systematic review will improve regulation, as potentially outdated rules will be removed or revised more consistently. The PSR will also be required to keep its

generally applicable requirements under review and publish a statement of policy on this.

**Methodology**

2.339 As set out above, the changes proposed through the FRF Review are to the overall framework and will therefore be for the regulators to implement. As such, the costs and benefits of operationalising these measures will be determined by the PRA, FCA and the PSR. However, the government has set out indicative costs for individual measures where this is possible.

2.340 Quantifying the specific impact on industry and consumers is not possible, since these changes will apply across all new regulator rules and it is not possible to assess the direct link between these accountability and engagement measures, the regulators' subsequent rules, and individual businesses. Furthermore, it is not appropriate for the government to prejudge how the operationally-independent regulators will implement these measures.

**Policy Costs**

2.341 The regulators, as operationally independent non-governmental bodies, are responsible for ensuring that they are resourced appropriately to discharge their responsibilities. They publicly consult on their annual budgets, which are funded by levies on financial services firms. For the FCA, its 2021/22 Annual Funding Requirement was estimated to be £613.7m.17 For the PRA, this was estimated to be £296.6m[18]. The PSR's Annual Plan and Budget for 2022/23 estimated costs of £20m.[19]As set out above, the government expects any increase in cost to be minimal as there are 51,000 firms the FCA regulates for conduct, 49,000 it supervises prudentially, and 18,000 it sets specific standards for. The PRA supervises around 1,500 firms. The regulators also consult publicly before raising fees or changing their structure.

2.342 The government has considered an indicative cost estimate for the regulator for two of the most significant proposals based on the cost to the regulators of similar existing functions.

CBA Panel

2.343 For the costs of operating a CBA panel, the FCA's Consumer Panel can be used as an example. The members of the Consumer Panel are paid expenses as well as a basic salary for their time. The regulators expect that CBA panel members would be paid

[17] *FCA Business Plan 2021/22*, Financial Conduct Authority, July 2021

[18] *PRA Business Plan 2021/22*, Prudential Regulation Authority, May 2021

[19] Annual Plan and Budget 2022/23, Payment Systems Regulator, March 2022

for their time. According to their latest annual report,20 the Consumer Panel's expenditure in the period of April 2017-March 2021 averaged ~£364,000 p.a. (excluding employer's National Insurance Contributions paid by the FCA). The proportion of this expenditure that goes to members' fees and expenses, as compared to other expenditure (such as research commissioned by the panel) varies from year to year. The panel is also supported by a Secretariat of five FTE staff.

Rule Review

2.344 The government does not expect a significant increase in costs as a result of the proposals relating to rule review.

2.345 However, if HM Treasury required the regulator to appoint an independent investigator to conduct a rule review, there may be additional costs. These could potentially be indicated by considering the cost of investigations under the section 77 power in the Financial Services Act 2012, which permits HM Treasury – where it considers that it is in the public interest - to direct the regulator to conduct an investigation into possible regulatory failure.

2.346 However, there some are some notable differences in the operation of the section 77 power and the proposed new rule review power.

2.347 Section 77 investigations consider relevant events, as opposed to reviews that consider rules currently in place. The cost of reviews will be heavily dependent on their scope and scale.

2.348 The two investigations carried out under section 77 so far have been both conducted by independent investigators, which may not always be the case for rule reviews.

2.349 The section 77 power has also been used infrequently, and a similar frequency for the new rule review power would also lower the expected annual cost of the measure. In the 9 years since section 77 came into force, HM Treasury has required the regulators to undertake 2 investigations under section 77; into Co-op Bank and London Capital & Finance plc which cost the regulators £1.8m and £6.7m, respectively.

2.350 Therefore, given the above differences in their purpose, and the potential significant differences in their operations, these costs should not be treated as a firm indication for the potential cost of this measure.

2.351 The final costs of establishing and complying with new accountability requirements overall will depend on how regulators choose to carry them out so it is not possible for government to estimate the costs. However, as many of the measures formalise existing practice and the regulators will have sufficient flexibility to introduce these in an efficient manner, the government expects the overall increased costs to be minimal, especially within the context of the overall FRF Review package.

2.352 The ability of the regulator to absorb costs from existing resource or reorganisation will determine if these requirements lead to an increase in overall cost for the

[20] *Annual Report 2020-2021*, FCA Consumer Panel, August 2021

regulators. At a minimum, the government expects that regulators will absorb costs related to measures which are formalising existing practice.

2.353 Where the government is putting a new requirement on the regulator, there may be an increased cost for the regulator. However, the proposals are intended to be implemented to provide the regulator with the flexibility to establish them in the most appropriate way; the regulators are also required to consider the efficiency of their use of resources as part of the existing regulatory principles.

2.354 There may be some transitional costs for the enhanced accountability mechanisms, depending on how the regulators choose to carry out their obligations. For example, these might include the costs of first setting up the secretariat for a CBA Panel.

2.355 There will be ongoing costs for the regulators to comply with new accountability requirements. The exact nature of these costs will depend on how the regulators operationalise the new measures.

2.356 In particular, there will be the ongoing cost of maintaining the CBA Panel. As stated above, it is not appropriate for the government to predict how this cost may be passed on to firms through regulators' fees, other than that it will likely to be a very small impact per firm, if it materialises.

2.357 One-off costs may arise in circumstances when the rule review power is exercised. The power is not expected to be used frequently, but may incur additional costs to the regulator when exercised. When exercising this power, HM Treasury must have regard to the desirability of minimising any adverse affect that it may have on the regulator or any of its other functions. As stated above, it is not appropriate for the government to predict how this cost may be passed on to firms through regulators' fees.

**Policy Benefits**

2.358 As the measures relating to the FRF Review are designed to be a framework for the future, benefits to businesses will be ongoing rather than one-off.

2.359 Immediate benefits of these measures include the publication of statements of policy, which will provide immediate transparency for stakeholders on how regulators conduct these operations. This will provide greater opportunities for stakeholders to engage with and influence the regulators action. In particular, it should increase the effectiveness of the regulators' policy making process and cost benefit analyses. Further benefits will materialise over the long-term as more new rules are introduced.

2.360 Overall, enhanced accountability mechanisms are intended to lead to more effective regulation, lowering costs for firms and consumers.

Accountability to Parliament

2.361 Obligations to notify and respond to Parliament seek to allow for more effective Parliamentary scrutiny, and potentially raise awareness of proposed reforms with the public, increasing stakeholder engagement with consultations. Effective Parliamentary scrutiny provides a valuable service for consumers, firms, and the

regulators. This will ensure that the regulators take Parliament's scrutiny into account and that the regulators' resources are appropriately targeted to consider appropriate democratic policy input from Parliament. Parliament acts in the public interest and its representations will ensure a focus on important public policy considerations.

2.362 Similarly, increased transparency of regulator operations seeks to also allow for more effective Parliamentary scrutiny.

Relationship with HM Treasury

2.363 Requiring the regulators to respond to HM Treasury's recommendations, outlining the action the regulator has taken or intends to take, or the reasons the regulator has not taken and does not intend to take action, on the basis of the recommendations. This will allow for more effective calibration of the recommendations by HM Treasury, leading them to be more useful for the regulators in creating effective regulation. The transparency provided should also help Parliamentary scrutiny and stakeholder engagement, which will in turn lead to more effective regulation, benefitting firms.

2.364 The power for HM Treasury to require the regulator to review their rules will be determined by a public interest test, so will seek to ensure better outcomes for industry and consumers. This means that a rule that is no longer achieving its purpose may be amended sooner, leading to accumulating benefits in the long-run and supporting more agile rulemaking.

Stakeholder engagement

2.365 Increased transparency of regulator operations aims to also help industry and consumers with engagement. More effective engagement, in turn, should lead to more effective and efficient regulation. The more effective regulation is, the larger the benefits it provides with lower costs. More effective engagement, in turn, will lead to more effective and efficient regulation.

2.366 The guarantee of consistent review of rules provided by the new general duty means more adaptive rulemaking, and the possibility to more quickly identify rules that are not working well. This will ensure that the consumers and industry benefit from rules that are more closely tailored to the current economic climate. Consistent review will also support better rulemaking by encouraging the regulator to identify improvements periodically. Transparent frameworks for review will allow for more effective stakeholder input, improving engagement with reviews. This should support overall improvements to how regulatory rulemaking reflects the views of stakeholders.

2.367 The regulators having a statutory requirement to create and publish frameworks for how they conduct cost-benefit analysis (CBA) and how they review their rules aims to systematise these practices and ensure they endure over time, making for more effective usage of CBA and rule review in the long-term. Creating and publishing frameworks for CBA and rule review will provide increased transparency regarding when stakeholders can expect a CBA to be conducted, and what that CBA will consist of, and will provide an opportunity for stakeholders to feed into how these

processes are conducted. In turn, this is expected to strengthen the robustness of policymaking and provide assurance to stakeholders that the regulators are seeking to understand the effect of their regulatory policymaking.

2.368 The CBA Panel seeks to provide enhanced external challenge to improve the overall quality of the regulator's production of CBA, and help to create rules that are more effective upon introduction. With increased scrutiny for the assumptions and quantification they are calibrated with, rules should be made with a better understanding of the costs and benefits they will provide for consumers and firms.

**Assumptions, limitations, and considerations**

2.369 Benefits will largely emerge over time as rules are made with the new mechanisms in place. The exact nature of the benefits will also be dependent on how regulators operationalise the new requirements, and the subsequent effect on future rules. Therefore, it would not be feasible to attempt to quantify them.

2.370 As explained in the introduction of this impact assessment, HM Treasury is content that the regulators will have in place appropriate mechanisms to consider the impact of such decisions.

2.371 More information on the FCA and PRA's approach to assessing costs and benefits, including how that will be bolstered by measures in this Bill can be found in the introduction to this impact assessment.

**Small and MicroBusiness Assessment (SaMBA)**

Number and distribution of businesses in scope of the regulation

2.372 As set out above, this measure will strengthen the accountability mechanisms underpinning Parliament's relationship with the financial services regulators, and improve the opportunities of consumers, firms and relevant stakeholders to engage with the development of regulatory proposals. This measure does not directly impact SMBs. However, the government anticipates these measures will have a future indirect impact on SMBs who are within the scope of PRA and FCA regulation.

2.373 To attempt to accurately estimate the number of small and microbusinesses impacted at the stage of secondary legislation would require HM Treasury to pre-judge policy decisions to be made in future by HM Treasury and by the independent financial services regulators. Many of the changes will be subject to consultation before decisions are made, , such as the final outcome of CBA panel development.. Any estimate given through such an enterprise would likely be inaccurate and out of date by the time the impact is felt by SMBs due to future, as yet unknown, policy decisions and potential unexpected changes in the UK's financial services markets. However, the government has provided an estimate of the number of firms currently regulated by the financial services regulators and therefore who may be indirectly impacted in future.

2.374 According to data provided by the PRA, the PRA currently regulate 1432 financial services firms, including 409 Credit Unions, 371 Capital Requirements Regulation (CRR) firms and 652 insurers. All 409 Credit Unions (100 per cent) can be classified as

SMBs (firms with less than 50 employees). The PRA did not have data on employee size for all CCR and insurance firms. However, using a threshold of turnover of less than £10.2 million the PRA estimate 25 CRR firms are SMBs21 (6.74 per cent) and at least 328 insurers are SMBs (50.3 per cent).[22] The government anticipates that these SMBs may be indirectly impacted by this measure in future, where this measure leads to changes in PRA rules or approach to stakeholder engagement.

2.375 Similarly, the FCA currently regulates over 50,000 firms. The FCA does not hold comprehensive data on the number of employees in these firms. Not all FCA regulated firms are required to report data to the FCA, and so only 38,599 out of the 50,000 firms regulated by the FCA have submitted turnover data for the 2021 financial end. Out of these 38,599 reporting firms, 34,533 (89%) can be classified as 'small' (turnover of less than or equal to £10.2 million). This data is based on the 2021 financial end for FCA regulated firms with an active status and where the data is stored and accessible from the FCA’s data lake. It does not cover data reported by firms who no longer have an active status. Where there are gaps, the FCA have looked to try to fill these using information from a survey conducted in response to the COVID-19 situation, though it should be noted that not all firms completed this. Using 89% as a proxy, HM Treasury estimates that approximately 44,500 SMBs are currently regulated by the FCA.As entities primarily operating in financial services, the government anticipates that these SMBs are likely to be in scope of the financial services regulators’ regulation, and so may be indirectly impacted by this measure where this measure leads to a change in the regulators’ rules or approach to stakeholder engagement.

2.376 It is worth noting that some of these financial services firms will have significant revenues despite being small in terms of the number of employees and may therefore not be disproportionately indirectly impacted as a result of this measure.

Do the impacts fall disproportionately on small and microbusinesses?

2.377 As explained above, it has not been possible to accurately quantify businesses within scope of this measure at this stage. For similar reasons it has also not been possible to quantify the costs and benefits to businesses of this measure and what proportion of these will fall on SMBs.

2.378 This will depend on any rules that are made by the regulators following the implementation of the changes in the Bill.

2.379 As explained at in the introduction to this impact assessment, the department is content that in such cases, the regulators will have in place appropriate mechanisms to consider the impact of such decisions on SMBs.

2.380 More information on the FCA and PRA’s approach to assessing costs and benefits to business, including how that will be bolstered by measures in this Bill can be found in

21 This excludes UK incorporated banks which are part of a wider banking group.

22 The PRA does not hold data on turnover amount for firms in the Temporary Permissions Regime (TPR) , firms in Supervised Run-Off (SRO), or for Gibraltar authorised insurers and did not provide an estimate of how many of these firms are SMBs.

the introduction to this impact assessment under Approach to Small and micro business assessment.

*Qualitative assessment of potential future costs and benefits on SMBs*

2.381 Although the government is unable to give an accurate quantitative assessment of future costs and benefits of this measure on SMBs at this stage given the various unknowns, the government has included the following qualitative assessment of how the potential expected costs and benefits for SMBs arising from the exercise of the powers in this measure in future.

*Benefits to SMBs*

2.382 As the measures relating to the FRF Review are designed to deliver a framework for the future, benefits to all businesses including SMBs will be ongoing rather than one-off.

2.383 The fact that this legislation will lead to the creation of a more agile and flexible framework, with an increased focus on growth and competitiveness, is highly likely to benefit small and microbusinesses as the regulators will be able to easily respond to market changes and adapt rules where necessary. This in turn will act to enable innovation, and to help the regulators more effectively deliver their competition objectives. The increased accountability mechanisms between Parliament and the regulators will benefit SMBs as, with more effective mechanisms for engagement, small and microbusinesses will be better able to engage in and influence the development of rules that apply to them. This will allow for those rules to better take account of and address the specific challenges and opportunities of small and microbusinesses.

2.384 The regulators' statements on appointments to the panels will also provide an opportunity to ensure that recruitment processes lead to better representation for small and microbusinesses. This will give their considerations more weight in panel discussion. The rules the panels have input on will therefore also be more likely to better take account of and address the specific challenges and opportunities of small and microbusinesses.

*Costs to SMBs*

2.385 There will be costs to regulators for setting up some of the measures, and ongoing costs to maintain, for example, the CBA Panels. As the regulators recover their running costs by levying fees from the firms they regulate, this may increase levy costs for SMBs authorised by the financial services regulators. However, such levies are structured to place the burden on larger firms. Therefore, any costs passed on via the levy should not fall disproportionately on SMBs.

Could small and microbusinesses be exempted while achieving the policy objectives

2.386 With respect to the provisions in this Bill, exemption would prevent SMBs from benefiting from the enhanced accountability mechanisms. With less effective input

into regulator rulemaking and review, SMBs would left at a disadvantage compared to larger firms that would be able to make use of enhanced mechanisms.

2.387 Exempting SMBs from regulations made with the benefit of enhanced accountability, and their possible effects, would also require the FCA and the PRA to have an entirely different process and set of rules for SMBs, which would be highly duplicative. Therefore, it would not be appropriate to exempt SMBs.

2.388 The existing framework for regulation governs whether or not SMBs are included within the scope of the regulators' rulemaking powers and supervision, and the enhanced accountability mechanisms are an amendment to this framework. SMBs inclusion in the scope of regulator rules and authorisation is determined by the activities they undertake. Within the scope afforded to them by the framework, the regulators will also be able to make decisions on whether it is appropriate, and in line with their duties, to exempt SMBs from rules made or amended with the influence of these amendments to the framework.

Could the impact on small and microbusinesses be mitigated while achieving the policy objectives?

2.389 To lessen the impacts of the new accountability mechanisms on SMBs would, similarly to exemption, require a more fundamental overhaul of the way FS regulation treats firms of differing sizes. The government is not considering such a change. The FCA and the PRA would need to have entirely different process and set of rules for SMBs, which would be highly duplicative. The benefits of these new mechanisms, such as more effective input by SMBs, and the existing proportionality principle are more effective ways to achieve mitigation of any new regulation's impact.

Wider impacts on small and microbusinesses.

2.390 More effective and agile financial services regulation will also extend to the wider economy, as FS firms are better and more safely able to provide credit, including to SMBs. By ensuring that consumer groups are better able to feed into regulator decision-making, the enhanced mechanisms will also contribute to better consumer protection in financial services; consumer protection is also one of the FCA's objectives, and so the FCA will advance it more effectively with better CBA and more frequent review of rules. This will benefit SMBs who are consumers of financial services.

## FRF Review: Deference and Trade Accountability Mechanisms

**Problem Under Consideration**

2.391 Deference arrangements and Trade agreements are part a range of tools that the government has to promote openness in financial services trade, facilitate cross border market access, and promote the growth and competitiveness of the sector. This section assesses two mechanisms, relating to the government's deference arrangements and the UK's international trade commitments, which provide additional accountability from the regulators to HM Treasury.

Deference Accountability Mechanism

2.392 Deference as it is applied to financial services is a process endorsed by the G20 where jurisdictions defer to each other when it is justified by the quality of their respective regulatory, supervisory and enforcement regimes.[23] Deference promotes trade by removing duplicating regulatory requirements for market participants conducting cross border activity; however, the way that it does so varies across deference provisions. For example, some provisions allow overseas firms to export financial services into the UK, and others remove duplicative requirements on cross-border business. 'Equivalence' is a form of deference.

2.393 Within the UK's system equivalence, which is an autonomous form of deference, is assessed on an outcomes basis. Where applicable equivalence is also assessed on the basis of compliance with internationally agreed standards. These assessments generally focus on whether the overseas jurisdiction's regulatory, supervisory and enforcement framework provides an equivalent outcome to the corresponding UK legal framework.

2.394 Deference is an important policy tool for promoting the UK as a global financial centre. The government is responsible for managing, granting, and (where relevant) agreeing deference arrangements with overseas jurisdictions. This includes nearly all of the EU equivalence decisions for overseas jurisdictions that were incorporated into UK law at the end of the transition period.[24] The government also intends to agree deference arrangements through Mutual Recognition Agreements with our overseas partners. In fulfilling this function, the government monitors these arrangements and keeps them under review such that it would be aware if the relevant regulatory and supervisory frameworks are no longer equivalent on an outcomes basis.

2.395 Once the UK moves to a comprehensive Financial Services and Markets Act 2000 ("FSMA") model of regulation, the regulators (Financial Conduct Authority, Prudential Regulation Authority, and the Bank of England (Bank)) will set the

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[23] September 6, 2013 St Petersburg Summit G20 Leaders' Declaration.

[24] The Government did not onshore equivalence decisions for Central Counterparties (CCPs) that the EU made under Article 25 of the European Market Infrastructure Regulation (EMIR - EU Regulation 648/2012).

regulatory requirements which apply to firms in their rulebooks. This will have a bearing on HM Treasury's responsibilities in managing the UK's deference framework. For example, if new firm-facing rules made by the regulators mean that overseas jurisdictions are no longer regarded as equivalent on an outcomes basis, HM Treasury may launch a review of the existing decision and ultimately revoke that decision.

2.396 Sections 144C(3) and (4) of FSMA require the Prudential Regulation Authority to consider and consult HM Treasury on the impact of relevant equivalence decisions when making rules relating to the Capital Requirements Regulation (CRR) or CRR Basel standards. Sections 143G (3) and (4) of FSMA, contain a similar requirement for the Financial Conduct Authority when making rules relating to the prudential regulation of investment firms regulated by the FCA. However, beyond considering the impact on deference when making rules in these areas, there is no general statutory requirement for the regulators to consider the impact of their rule changes on the remainder of HM Treasury's deference framework, nor to consult HM Treasury on the nature and likelihood of these impacts. Doing so is expected to improve the quality of information available to regulators when exercising their regulatory powers.

Trade Accountability Mechanism

2.397 HM Treasury can currently direct the FCA, PRA and the Bank in exercising certain functions under Section 410 FSMA to take or refrain from taking a particular action in pursuance of the UK's international obligations.

2.398 Since the regulators (the FCA, PRA, the Bank and the PSR) will have greater responsibility to set the regulatory requirements which apply to firms following the implementation of the FRF, the number of interactions between their rulemaking and the UK's international trade commitments are also likely to increase. Therefore, it is appropriate to establish a formal notification mechanism to prevent and mitigate the impact of any potential incompatibility.

**Rationale for Intervention**

2.399 There is a risk that the regulators' actions could have consequences for HM Treasury's ability to maintain deference decisions, or come into conflict with the UK's compliance with its international obligations under its trade agreements. In relation to the Deference Accountability Mechanism, given that HM Treasury ministers have the power to make deference decisions following advice from the relevant regulator(s), it is necessary for the regulators to consider both whether there is a material risk that their proposed action could be incompatible with HM Treasury's deference decisions and consult HM Treasury on the likelihood that their proposed action might lead HM Treasury to review or repeal a decision.

2.400 In relation to the Trade Accountability Mechanism, if the regulators used their powers to take action that undermined trade agreements, there is the potential for trade partners to use trade dispute mechanisms until the offending rules were removed.

**Policy Objective**

2.401 The intention is to ensure that, when exercising rule making powers and setting supervisory policy about which it consults the public, the regulators (the FCA, PRA and the Bank) must consider the impact of their actions upon relevant deference decisions made by HM Treasury in respect of overseas jurisdictions and consult HM Treasury if they consider that there is a material risk the relevant action could be incompatible with the relevant deference decision.

2.402 With regards to the UK's international obligations arising from trade agreements, HM Treasury proposes an accountability mechanism that requires the regulators to assess the implication of their proposed rules or supervisory policies, and to notify HM Treasury if they believe there is a material risk the relevant action could be incompatible with an international trade obligation. This requirement would ensure that the regulators consider whether their rules would likely cause a breach of the UK's trade commitments. The accountability mechanism in the FSMA applies to the FCA, PRA and the Bank. Analogous provision (in the Financial Services (Banking Reform) Act 2013) will apply in relation to the PSR.

2.403 The Deference Accountability Mechanism and Trade Accountability Mechanism will only apply to the Bank in relation to its regulation of Central Counterparties and Central Securities Depositories. This is to be consistent with the scope of the wider FRF Review changes taken forward in the Bill regarding the regulation of FMIs by the Bank. These changes are covered in more detail in the 'FRF Review: Regulation of FMI by the Bank of England' section below.

**Description of options considered**

Deference Accountability Mechanism

2.404 Option 0: (Do Nothing) – As set out in the FRF Review: Repeal of retained EU law section of this impact assessment, if no action is taken, the regulation of the UK's financial services sector will continue in its current form: a mixture of FSMA regulation, and the EU regulation which was in place at the point of leaving the EU.

2.405 As explained above, while this retained EU law remains in place, the expert regulators are not properly able to carry out the role that Parliament has given them under FSMA and regulate such activities in a way which furthers their statutory objectives, and which is tailored to UK markets and consumers.

2.406 Most rule changes would need to be made by the government via legislation, rather than the regulators being able to adapt their rules as they can under the FSMA model. This would place inappropriate and substantial resource pressures on Parliament.

2.407 Option 1 (Preferred Option) – Repeal retained EU law and introduce a statutory requirement for the regulators (FCA,PRA and the Bank), when undertaking their rule-making and certain supervisory policy-making responsibilities, to consider the impact of their actions upon deference decisions and if they consider there to be a material

risk that the relevant action would be incompatible with a deference decision, consult HM Treasury about this.

2.408 This mechanism would not constitute a HM Treasury veto or require the regulators to proactively take action to pursue the maintenance of deference arrangements unless doing so would better achieve their statutory objectives.

2.409 As set out under the FRF Review: Repeal of retained EU law measure above, the government intends to repeal all retained EU relating to financial services.

2.410 For the government to commence the repeal of retained EU law legislated for in this Bill in full, the regulators will take on greater rulemaking responsibility for areas currently regulated by retained EU law.

2.411 Once the UK moves to a comprehensive Financial Services and Markets Act 2000 ("FSMA") model of regulation, the regulators will set the regulatory requirements which apply to firms in their rulebooks. This will have a bearing on HM Treasury's responsibilities in managing the UK's deference framework.

2.412 Without a requirement to consider these impacts, regulators may set rules or supervisory practices which impact upon deference decisions but the impact on these decisions may not be fully factored into the regulators' decision-making processes. Although HM Treasury has an arrangement with the regulators to monitor the UK's deference decisions, this needs to be strengthened and put on a statutory basis.

Trade Accountability Mechanism

2.413 Option 0: (Do Nothing) – As set out in the FRF Review: Repeal of retained EU law section of this impact assessment, if no action is taken, the regulation of the UK's financial services sector will continue in its current form: a mixture of FSMA regulation, and the EU regulation which was in place at the point of leaving the EU.

2.414 As explained above, while this retained EU law remains in place, the expert regulators are not properly able to carry out the role that Parliament has given them under FSMA and regulate such activities in a way which furthers their statutory objectives, and which is tailored to UK markets and consumers.

2.415 Most rule changes would need to be made by the government via primary legislation, rather than the regulators being able to adapt their rules as they can under the FSMA model. This would place inappropriate and substantial resource pressures on Parliament.

2.416 Option 1 (Preferred Option) – Repeal retained EU law and introduce statutory requirements for the regulators (FCA, PRA, the Bank, and PSR) to proactively consider whether there is a material risk that a rule change or change of supervisory approach would conflict with an existing international trade obligation, and to notify HM Treasury if this is the case.

2.417 As set out under the FRF Review: Repeal of retained EU law measure above, the government intends to repeal all retained EU relating to financial services.

2.418 For the government to commence the repeal of retained EU law legislated for in this Bill in full, the regulators will take on greater rulemaking responsibility for areas currently regulated by retained EU law.

2.419 Once the UK moves to a comprehensive Financial Services and Markets Act 2000 ("FSMA") model of regulation, the regulators will set the regulatory requirements which apply to firms in areas currently covered by retained EU law in their rulebooks. As a result, the number of interactions between their rulemaking and the UK's international trade commitments are also likely to increase.

2.420 Taking no further action following the transfer of rule-making responsibility to the regulators would mean that HM Treasury does not have a fully robust framework for the exchange of information regarding regulatory rulemaking conflicts with the UK's international trade obligations. This could result in a claim being made against the UK under an international Free Trade Agreement (FTA) dispute. An FTA conflict can impact any economic area under the trade agreement, potentially leading to significant economic costs. By doing nothing, HM Treasury would have to rely on existing mechanisms (s410 FSMA) to direct the regulators and avoid such a claim, which would be inadequate to appropriately manage the risk of conflict between regulatory rulemaking and the UK's international trade obligations.

**Outline of Preferred Policy**

2.421 HM Treasury will introduce a statutory requirement to necessitate the regulators (FCA, PRA, and the Bank) to consider, when setting rules or general supervisory policies and practices on which the regulators are required to publicly consult, the effect of their proposed action on a deference decision which HM Treasury has previously notified the regulators is relevant to this requirement. If there is a material risk that their action is incompatible with a notified deference decision, the regulators must consult HM Treasury prior to taking any action. The requirement will be restricted to the impact on the deference decision, not the substance of the regulator's proposed action.

2.422 For the Trade Accountability Mechanism, the proposal is to add requirements for the regulators (FCA, PRA, the Bank, and PSR) to consider whether a proposed action would give rise to a material risk that it would be incompatible with an international trade obligation. Where this is found to be the case, they will be required to notify HM Treasury.

2.423 The preferred policy creates a framework for HMT and the regulators to operate under when considering deference and trade related issues.

**Methodology**

2.424 The regulators, as operationally independent public bodies, are responsible for ensuring that they are resourced appropriately to discharge their responsibilities. This measure only applies to public sector regulators and is therefore out of scope of the Better Regulation Framework.

2.425 As the regulators are operationally independent, it is not appropriate for the government to quantity the impact of any possible rule changes, and the

implementation of this measure, as doing so would pre-judge the independent decisions of the regulators.

**Policy Costs**

2.426 This policy only has an impact on public bodies and is, therefore, out of scope of the Better Regulation Framework.

2.427 It is not possible to estimate the costs to regulators as these will depend on the internal operational structures the regulators choose to put in place to meet the obligations under the Act. It will further depend on the extent to which regulators make relevant changes to their rules and supervisory policy on which they consult.

**Policy Benefits**

2.428 Under the Deference Accountability Mechanism the regulators, when undertaking their rule-making and certain supervisory policy-making responsibilities, will be required to consider the impact of their actions upon deference decisions and, if they consider there to be a material risk that the relevant action would be incompatible with a deference decision, consult HM Treasury.

2.429 As outlined above once the UK moves to a comprehensive Financial Services and Markets Act 2000 ("FSMA") model of regulation, the regulators (Financial Conduct Authority, Prudential Regulation Authority, and the Bank) will have set the direct regulatory requirements which apply to firms in their rulebooks. Many of these requirements will have a bearing on the criteria under which deference is assessed. Including a statutory requirement for the regulators to consult HM Treasury on any changes that raise a material risk to HM Treasury's deference decisions, may provide for enhanced coordination between HM Treasury and the regulators on deference matters. Firms which conduct cross border activities under HM Treasury's deference decisions may therefore benefit from this enhanced coordination.

2.430 Similarly, the Trade Accountability Mechanism will improve the flow of information between the regulators and HM Treasury about the interaction of regulatory rulemaking and trade commitments. This will reduce the risk of a dispute arising under an FTA due to a potential breach of the trade commitments arising from regulatory rulemaking. This will help avoid a potential dispute, that could be damaging to the UK's economic and diplomatic relations with overseas jurisdictions. Firms which benefit from protections under the provisions in the UK's trade agreements may therefore benefit from this enhanced coordination between HM Treasury and the regulators.

Assumptions, limitations, and considerations

2.431 N/A

**Small and MicroBusiness Assessment (SaMBA)**

Number and distribution of businesses in scope of the regulation

2.432 This measure does not directly impact small or microbusinesses. As set out above, these mechanisms are designed to ensure an accountability framework between HMT and the relevant regulators to ensure there is due consideration regarding the impact of their actions on HM Treasury's deference arrangements and HM Treasury's international obligations within the UK's free trade agreements. These measures also serve to ensure there is effective information sharing between HM Treasury and the regulators on these impacts. Firms, including small and microbusinesses, are therefore not within the scope of this regulation.

2.433 As these mechanisms are designed to ensure an accountability framework between HMT and the relevant regulators these mechanisms will not result in a direct impact to business. Firms, including SMBs, which conduct cross border activities that benefit from HM Treasury's deference arrangements or the UK's trade agreements may therefore benefit from the enhanced coordination between HM Treasury and the regulators provided through these mechanisms.

2.434 According to data provided by the PRA, the PRA currently regulate 1432 financial services firms, including 409 Credit Unions, 371 Capital Requirements Regulation (CRR) firms and 652 insurers. All 409 Credit Unions (100 per cent) can be classified as SMBs (firms with less than 50 employees). The PRA did not have data on employee size for all CCR and insurance firms. However, using a threshold of turnover of less than £10.2 million the PRA estimate 25 CRR firms are SMBs[25] (6.74 per cent) and at least 328 insurers are SMBs (50.3 per cent)[26]. The government anticipates that these SMBs may be indirectly impacted by this measure in future, where this measure leads to changes in PRA rules.

2.435 Similarly, the FCA currently regulates over 50,000 firms. The FCA does not hold comprehensive data on the number of employees in these firms. Not all FCA regulated firms are required to report data to the FCA, and so only 38,599 out of the 50,000 firms regulated by the FCA have submitted turnover data for the 2021 financial end. Out of these 38,599 reporting firms, 34,533 (89%) can be classified as 'small' (turnover of less than or equal to £10.2 million). This data is based on the 2021 financial end for FCA regulated firms with an active status and where the data is stored and accessible from the FCA's data lake. It does not cover data reported by firms who no longer have an active status. Where there are gaps, the FCA have looked to try to fill these using information from a survey conducted in response to the COVID-19 situation, though it should be noted that not all firms completed this. Using 89% as a proxy, HM Treasury estimates that approximately 44,500 SMBs are currently regulated by the FCA. HM Treasury does not hold data regarding the number of SMBs as outlined above which conduct activities relevant to HM Treasury's deference arrangements and the UK's trade agreements.

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[25] This excludes UK incorporated banks which are part of a wider banking group.

[26] The PRA does not hold data on turnover amount for firms in the Temporary Permissions Regime (TPR) , firms in Supervised Run-Off (SRO), or for Gibraltar authorised insurers and did not provide an estimate of how many of these firms are SMBs.

Do the impacts fall disproportionately on small and microbusinesses?

2.436 As set out above, these mechanisms are designed to ensure an accountability framework between HMT and the relevant regulators. Therefore, no small or microbusinesses are directly or indirectly impacted by the measures, therefore the impacts do not fall disproportionately on them.

2.437 As outlined above Small and MicroBusinesses, which conduct cross border activities facilitated through HM Treasury's deference arrangements or the UK's trade agreements may benefit in future from the enhanced coordination between HM Treasury and the regulators provided through these mechanisms.

Could small and microbusinesses be exempted while achieving the policy objectives?

2.438 As set out above, these mechanisms are designed to ensure an accountability framework between HMT and the relevant regulators. Therefore, as small and microbusinesses are not impacted, there is no need to exempt them.

Could the impact on small and microbusinesses be mitigated while achieving the policy objectives?

2.439 As set out above, these mechanisms are designed to ensure an accountability framework between HMT and the relevant regulators. Therefore, as small and microbusinesses are not impacted, there is no need to mitigate the impact.

Wider impacts on small and microbusinesses

2.440 As set out above, these mechanisms are designed to ensure an accountability framework between HMT and the relevant regulators. Therefore, there is no direct impact upon businesses. The intention of the deference mechanism is to improve the quality of information available to the regulators when exercising their regulatory powers, and therefore support HM Treasury's management of deference arrangements. The trade mechanism is designed to ensure the that the regulators consider the impact of their decision making on trade agreements and share information on their considerations with HM Treasury so that HM Treasury can take appropriate action if the decision making of the regulators is likely to lead the UK to being in breach of its trade agreements.

2.441 As this mechanism is to enable information sharing between the regulators and the government these mechanisms will not result in an impact to business, either directly or indirectly. However firms, including small and microbusinesses, which conduct cross border activities facilitated through HM Treasury's deference arrangements or the UK's trade agreements may therefore benefit from the enhanced coordination between HM Treasury and the regulators provided through these mechanisms. Moreover, both mechanisms will help the Government implement its strategy to support cross border financial services with the intention that this will generally promote the international competitiveness of the sector which may benefit small and micro businesses conducting cross border activities.

## FRF Review: Regulation of FMI by the Bank of England

**Problem Under Consideration**

2.442 The Bank of England ('the Bank') is responsible for supervising and regulating, amongst other entities, central counterparties (CCPs) and central securities depositories (CSDs). CCPs and CSDs are both types of Financial Market Infrastructure (FMI). FMI are institutions that underpin the global financial system, acting as conduits between many other financial services firms. They help maintain stability in the financial services sector and provide critically important functions that help make markets safer and more efficient.

2.443 Firms use CCPs to reduce certain risks that arise when entering into financial transactions with other parties, such as derivative transactions or buying and selling securities. CCPs sit between the buyers and sellers of financial contracts, providing assurance that the obligations under those contracts will be fulfilled. Instead of holding the contract with each other, the buyer and seller each hold their side of the contract with the CCP instead. The process of transacting through a CCP is known as "clearing".

2.444 CSDs hold financial instruments (securities), such as shares, and have roles in the issuance, settlement and maintenance of these instruments. They also play a key role when ownership of a security is transferred, including transferring the cash and securities between market participants and managing all the rights and obligations linked to the ownership of a security.

2.445 As with other areas of financial services, the regulation and supervision of UK CCPs and CSDs has been heavily influenced by the UK's membership of the EU. In 2009, following the financial crisis, the G20 agreed that CCPs should play a more central role in financial markets. This increased responsibility required a more robust prudential rulebook for CCPs. As such, a more robust set of international standards for FMI was agreed by the Committee on Payments and Settlement Systems (now the Committee on Payments and Market Infrastructures) of the Bank for International Settlements and the Technical Committee of the International Organisation of Securities Commissions (CPMI-IOSCO) – these were the Principles for Financial Market Infrastructures (PFMIs). The PFMIs covered CCPs as well as a broader range of FMI.

2.446 The PFMIs were implemented in the EU by the European Market Infrastructure Regulation (EMIR) and the Central Securities Depositories Regulation (CSDR). These Regulations set out a much more comprehensive regime for these entities and were incorporated into the recognition regime for CCPs and CSDs which already existed, in a relatively light touch form, in FSMA. The government strongly supports the high standards set out within these regulations.

2.447 The government believes that, in line with the comprehensive FSMA model, the Bank, in its role as the expert, independent regulator of CCPs and CSDs, should take on primary responsibility for setting regulatory requirements for these entities.

2.448 As set out in the previously section, the government intends to repeal retained EU law, so that regulatory requirements can be set by the relevant regulator in accordance with the FSMA model. However, the Bank of England has limited rulemaking powers over CCPs and CSDs, and so would not be able to make the necessary rules. In addition, the Bank's statutory objectives and the mechanisms by which it is held accountable by HM Treasury and Parliament are only designed around, and appropriate for, the Bank's existing limited rulemaking powers.

2.449 In January 2022, the government consulted on how to apply the Future Framework Review to CCPs and CSDs, and how these problems could be addressed.[27] Respondents to the consultation supported HM Treasury's proposals for the Bank to take on primary responsibility for setting regulatory requirements for CCPs and CSDs with appropriate changes to its statutory objectives and accountability arrangements. This measure implements the results of that consultation.

2.450 As noted, there are two specific types of firms affected – CCPs and CSDs. There are currently 3 UK CCPs (LCH Limited, LME Clear Limited and ICE Clear Europe Limited), and one UK CSD (Euroclear UK and International).

**Rationale for Intervention**

2.451 Without legislative intervention, the Bank would continue to have limited powers to make rules for CCPs and CSDs and would not be able to place appropriate requirements on these entities once retained EU law has been repealed.

2.452 HM Treasury believes that these changes will also help ensure that the Bank's real-world, day-to-day experience of supervising CCPs and CSDs can more directly feed through into the regulatory policymaking process. The measure should also provide the Bank with the flexibility to update standards efficiently in response to changing market conditions and emerging risks. This approach to regulation is internationally respected and should help ensure that the UK continues to be a leader in the development of international standards for CCPs and CSDs.

**Policy Objective**

2.453 The intention is to ensure that the Bank has the necessary rulemaking powers to take full responsibility for these entities once retained EU law has been repealed. This also requires creating an appropriate statutory framework in primary legislation for the Bank's regulation of these firms, including updated statutory objectives to consider public policy priorities, more effective accountability to HM Treasury and to Parliament and increased transparency to external stakeholders.

**Description of options considered**

2.454 Option 0 (Do Nothing) - As set out in the FRF Review: Repeal of retained EU law section of this impact assessment, if no action is taken, the regulation of the UK's financial services sector will continue in its current form: a mixture of FSMA regulation, and the EU regulation which was in place at the point of leaving the EU.

[27] The Future Regulatory Framework Review: Central Counterparties and Central Securities Depositories HM Treasury, January 2022

2.455 As explained previously, doing nothing will mean that the UK's regulators are not properly able to effectively supervise and regulate these entities in a way which furthers their statutory objectives and which is tailored to UK markets and consumers.

2.456 Most rule changes would need to be made by the government via primary legislation, rather than the regulators being able to adapt their rules as they can under the FSMA model. This would place inappropriate and substantial resource pressures on Parliament.

2.457 Option 1 (Preferred Option) – Repeal retained EU law and introduce a new general rule-making power and accountability framework for the Bank.

2.458 As set out previously under the FRF Review: Repeal of retained EU law measure, the government intends to repeal all retained EU relating to financial services.

2.459 For the government to commence the repeal of retained EU law legislated for in this Bill the regulators will need to take on greater rulemaking responsibility for areas currently regulated by retained EU law.

2.460 The Bank of England has very limited rulemaking powers over CCPs and CSDs and does not currently have the necessary rulemaking powers to replace the retained EU law which applies to these entities once it has been repealed or to ensure that the regulatory regime continues to be fit for purpose. Given the systemic importance of these entities, this is not an acceptable solution.

2.461 The government has also considered ensuring that the Bank has the necessary powers, but not making wider changes to the Bank's framework for the regulations of CCPs and CSDs. As set out in the government's January consultation, such a power would mean that the Bank's rule-making powers would be broadly equivalent to that of the PRA and FCA in respect of the firms they authorise and regulate. However, the PRA and the FCA have a number of objectives and principles which they must reflect when making rules. At the moment the statutory framework that applies to the Bank does not account for the Bank directly imposing detailed regulatory requirements on CCPs and CSDs as these requirements are mostly set out in retained EU law.

2.462 The government believes that, if the Bank of England is to be granted a general rule-making power in respect of CCPs and CSDs, this must be accompanied by appropriate enhancements to the mechanisms by which the Bank is held accountable. These mechanisms would be similar to those that are either already in place for the PRA and FCA or are being implemented elsewhere in this legislation.

2.463 The government's preferred option is therefore to implement the proposals in the January consultation, and to grant the Bank a general rule-making power in relation to CCPs and CSDs (modelled on the PRA and the FCA's general rule-making powers) so that it can set appropriate rules for these firms. The government also intends to put in place a framework to ensure that the Bank – as the expert, independent regulator – is set the right overall objectives and is fully accountable and transparent in pursuing them. The responses to the January consultation were highly supportive

of this approach. As this measure makes changes to the Bank's regulatory framework, primary legislation is needed.

2.464 It is important to note that these changes will be made in relation to the Bank's role over CCPs and CSDs only, and do not impact the Bank's other functions.

**Outline of preferred policy**

2.465 The Bill will grant the Bank a general rule-making power in relation to CCPs and CSDs so that it can set appropriate rules for these firms. This is modelled on the FCA's general rule-making power in section 137A of FSMA and the PRA's general rule-making power in section 137G of FSMA.

2.466 The government believes that a general rule-making power is appropriate given the fundamental importance of CCPs and CSDs to the safe and smooth running of the UK's financial system. This importance means that CCPs and CSDs are, and should continue to be, subject to robust regulatory oversight which is not limited in scope to the specific areas currently provided for in domestic legislation. Such a power would provide the Bank with an effective way to uphold and enhance standards for CCP and CSD regulation, including a means to make new rules for these firms, to address emerging risks and keep pace with international standards. It would therefore enable rule-making to become more agile, responsive and adaptable.

2.467 The Bill maintains the effect of the current overseas framework where the Bank defers to the home regulator where appropriate but may subject systemically important third country CCPs to UK regulation and oversight. The Bill achieves this by establishing the concept of a "systemic third country CCP" and providing for the Bank to be able to apply its rulebook for domestic CCPs, in part or entirely, to these firms. The Bank will continue to have powers to defer to the home regulators of these firms where appropriate.

2.468 The Bill also grants HM Treasury powers to change the overseas framework in the future to grant the Bank further powers to apply domestic rules to non-systemic overseas CCPs and overseas CSDs.

2.469 The Bill puts in place a revised set of statutory objectives and principles that will guide the Bank's regulation of CCPs and CSDs. The government believes that the Bank's financial stability objective ('to protect and enhance the stability of the financial system of the United Kingdom') must remain the sole primary objective for the Bank in its regulation of CCPs and CSDs. There are also some additions to the framework to reflect that, when pursuing this objective, the Bank should also: (a) consider the effects generally that its regulation of CCPs and CSDs will or may have on the financial stability of countries or territories (other than the UK) where CCPs and CSDs are established or provide services, and (b) have regard to regulating CCPs and CSDs in a way that is not determined by whether the users of their services are located in the UK or elsewhere. In practice the government believes that the Bank already does both of these things, but considers it useful to formalise this internationally cooperative approach in legislation.

2.470 The Bill will also give the Bank a secondary objective so that, as it advances its primary objective for financial stability, it must, so far as is reasonably possible,

facilitate innovation in the clearing and settlement services provided by the CCPs and CSDs it regulates with a view to improving the quality, efficiency and economy of the services they provide.

2.471 The legislation applies the FSMA regulatory principles, which are already in place for the PRA and FCA, to the Bank, including a principle which references the government's commitment to achieving net zero by 2050. This includes a small clarification to 'the general principle that consumers should take responsibility for their decisions' to note that the term 'consumer' includes firms that receive CCP and CSD services. The legislation also introduces a new principle for the Bank to have regard to the desirability of facilitating fair and reasonable access to these services.

2.472 The legislation expands the Bank's powers of direction over CCPs and CSDs. Currently the Bank can direct these firms to take specified actions under limited circumstances, such as where a firm has failed to comply with an obligation under FSMA or where the Bank considers it necessary to do so to protect and enhance the stability of the UK financial system. In line with the approach to delegate increased responsibility to the Bank and to provide them with the appropriate tools to advance their updated objectives, the Bill will provide the Bank with the power to impose, vary or cancel a requirement on a CCP or CSD where it is desirable to do so in order to advance its financial stability objective, or where the firm has failed or is likely to fail to comply with a recognition requirement or other obligation under FSMA. This includes the ability for CCPs and CSDs to apply for a 'voluntary requirement' to be placed on them, as is already the case for firms regulated by the FCA and the PRA.

2.473 The Bank's current accountability arrangements are designed around, and appropriate for, the Bank's limited set of rule-making powers. Therefore, the legislation also aims to enhance the legislative framework that applies to the Bank so that there is appropriate accountability to government and Parliament, and so other stakeholders are given an appropriate opportunity to engage with and scrutinise policy development. This will bring the Bank's framework for CCPs and CSDs into line with those of the PRA and FCA over authorised persons.

2.474 The Bill will also create a new statutory decision-making committee at the Bank for its regulation of CCPs and CSDs, which is designed to increase transparency and accountability in decision making and the use of the new rule-making power. This will bring this area of regulation in line with the Bank's other activities which have statutory committees (such as the Prudential Regulation Committee, which is responsible for exercising the Bank's functions).

2.475 The legislation introduces a requirement for the Bank to report annually on the efforts it has made to engage with stakeholders outside of its regulation, such as users of CCP and CSD services, and a summary of this engagement. This is intended to increase transparency around this engagement while continuing to give the Bank flexibility on the approach it wishes to take.

2.476 As this measure requires a number of changes to the Bank's regulatory framework, these changes are made through primary legislation, principally additions and amendments to FSMA and the Bank of England Act 1998.

**Methodology**

2.477 The changes proposed through the FRF Review are to the overall framework and will therefore be for the regulators to implement. As such, the costs and benefits of operationalising these measures will be determined by the regulators. However, the government has set out indicative costs for individual measures where this is possible.

2.478 This legislation enables the Bank to set regulatory requirements for CCPs and CSDs, within an appropriate regulatory framework. As the Bank is an operationally independent regulator of these entities, it would not be appropriate for the government to prejudge the rules they will make. Therefore, it is not possible to quantify the cost of any rules that they may make in the future once retained EU law has been repealed.

2.479 Generally, the benefits of establishing a framework for the regulation of these entities will manifest themselves in the increased agility and adaptability of regulation in the longer term, as well as the fact that rules will be made by the independent experts in this area.

2.480 Once the Bank's powers are in place it may make whatever changes it deems necessary or expedient to the regulatory regime for these firms, as guided by its updated statutory objectives. Any changes would be subject to the usual process of consultation, cost-benefit analysis and engagement with the firms affected, as well as the updated accountability mechanisms proposed within the measure.

**Policy Costs**

2.481 As set out above, no costs can be quantified at this stage. The legislation will give responsibility to the Bank for setting firm-facing requirements on CCPs and CSDs and does not impose specific requirements on firms themselves. The Bank should estimate the impact of any future rules it makes as part of its cost benefit analysis. HM Treasury expects that there may be some transitional costs for CCPs and CSDs as firm facing requirements are moved from retained EU law into Bank rules but that these cannot be quantified at this stage.

2.482 There will be an additional cost to the Bank of England from operationalising the new regime. The Bank, as an operationally independent non-governmental body, is responsible for ensuring that it is resourced appropriately to discharge its responsibilities. As part of this, the Bank introduced a levy in August 2018 on all Bank regulated Financial Market Infrastructures (FMI) to cover its FMI supervisory costs[28]. In 2020/21, the Bank's expenditure on FMI supervisory functions totalled £10 million[29]. If there is any change in the Bank's supervisory operating costs, these costs will be passed on to industry through the levy.

**Policy Benefits**

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28 P.37 Bank of England Annual Report and Accounts 1 March 2020-28 February 2021

29 P.40, Bank of England Annual Report and Accounts 1 March 2020-28 February 2021

2.483 As the measures relating to the FRF Review are designed to deliver a framework for the future, benefits to businesses will be ongoing rather than one-off.

2.484 As is the case for policy costs, the benefits of the policy cannot be quantified at this stage as they will be dependent on future decisions made independently by the Bank. However, HM Treasury expects that the Bank will be able to leverage its status as the expert, independent regulator of these firms to deliver a robust regulatory regime, befitting the high level of risk that these firms are responsible for managing. This is underpinned by financial stability remaining the sole primary objective for the Bank in its regulation of CCPs and CSDs, which will help minimise the risk of a financial stability event which could destabilise financial markets and harm consumers and the economy.

2.485 As noted, the Bill also gives the Bank a secondary objective so that, as it advances its primary objective for financial stability, it must, so far as is reasonably possible, facilitate innovation in the clearing and settlement services provided by the CCPs and CSDs regulated by the Bank with a view to improving the quality, efficiency and economy of the services they provide. How the Bank implements its objectives is for it to decide and it is therefore not appropriate for HM Treasury to speculate on the effect of the new objective. However, there is likely to be a beneficial impact on innovation within the sector which may then feed through into greater benefits for the end consumer.

2.486 HM Treasury expects that the new regime should be more agile, responsive and adaptable, with the measure allowing the Bank to quickly and effectively address emerging risks. It is designed to ensure that the UK's regulatory regime can be adapted to reflect the UK market while keeping pace with international standards. Firms will benefit from this increased regulatory adaptability.

**Assumptions, limitations, and considerations**

2.487 The impact of rules made by the Bank in comparison to retaining the current rules cannot be predicted at this stage as this will depend on the decisions made by the Bank as part of its full policymaking processes.

2.488 The benefits of the legislation are also similarly dependent on what the rules the Bank will decide to make and therefore cannot be quantified at this stage.

**Small and MicroBusiness Assessment (SaMBA)**

Number and distribution of businesses in scope of the regulation

2.489 This measure applies only to UK CCPs and CSDs – there are 3 CCPs in the UK and one CSD[30], all of which are authorised and supervised by the Bank of England. All of these firms are part of large multinational groups with well over 50 employees. Firm-level data on the number of employees of each CCP and CSD is not available but based on public financial statements none of these firms could be classed as small businesses as they all have annual turnovers over £10m[31].

2.490 No future CCP or CSD established in the UK is expected to be a small or microbusiness - any new entrant to the market would likely be one part of a large financial services group, as is the case with the current set of firms. The services that CCPs and CSDs provide are technically complex and would require a level of investment to set up and run which is likely beyond the means of any small or microbusiness. The nature of the markets in which these firms operate also does not lend itself to small-scale competitors. Due to the strong economies of scale in the clearing market for instance, the global market for specific products can be dominated by an individual firm and it would be challenging for a small or microbusiness to compete in terms of liquidity or pricing. CSDs are more domestic in nature but, given the nature of the services they provide, there tends to only be one CSD per jurisdiction.

Do the impacts fall disproportionately on small and microbusinesses?

2.491 No small or microbusinesses are directly impacted by the measure, therefore the impacts do not fall disproportionately on them.

Could small and microbusinesses be exempted while achieving the policy objectives?

2.492 As small and microbusinesses are not directly affected, there is no need to exempt them.

Could the impact on small and microbusinesses be mitigated while achieving the policy objectives?

2.493 As there is no direct impact on small and microbusinesses, there is no need to mitigate the impact.

Wider impacts on small and microbusinesses

2.494 This measure will allow the UK to move to a comprehensive FSMA model of regulation in this area. This model will be tailored specifically for, and capable of quickly reacting to, emerging opportunities and challenges in UK financial markets. Small and microbusinesses will benefit indirectly from the measure as it will enable a comprehensive and agile approach to the regulation of CCPs and CSDs by the Bank of

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30 https://www.bankofengland.co.uk/financial-stability/financial-market-infrastructure-supervision

31 https://www.lch.com/system/files/media_root/2021_lch_group_stat_accounts_ey.pdf;
https://www.ice.com/publicdocs/clear_europe/ICE_Clear_Europe_Limited_Statutory_Accounts_2021_UK_GAAP.pdf;
https://www.lme.com/about/governance/lme-clear-governance/Financial-statements;
https://www.euroclear.com/content/dam/euroclear/investor-relations/annual-reports/2021/Documents/IR4311_EUI_Financial_Statements_2021.pdf

England. This will provide the Bank with the rulemaking powers it needs to pursue its primary goal of protecting and enhancing UK financial stability and to uphold high standards of robust regulation. This benefits the UK economy generally, and the firms who use the services of CCPs and CSDs, either directly or through an intermediary. It also introduces a secondary objective for the Bank to facilitate innovation in the provision of CCP and CSD services, with a view to improving the quality, efficiency and economy of these services, and makes the Bank more accountable and transparent, including to industry stakeholders, in this area of regulation. These aims can benefit all firms participating in the financial services industry and the wider economy, including small and microbusinesses.

## FRF Review: FCA Financial Market Infrastructure

**Problem Under Consideration**

2.495 Retained EU law currently contains frameworks to regulate a number of entities, which facilitate the proper functioning of financial markets. In the UK, in addition to the entities covered above which are the responsibility of the Bank of England (Bank), the FCA is also responsible for the supervision of these some of these entities, and for ensuring compliance with relevant rules. However, as the rules currently mainly sit in retained EU law, the FCA does not have significant rule-making powers in relation to these entities.

2.496 These entities are:

a. Data Reporting Service Providers (DRSPs); and

b. Recognised Investment Exchanges (RIEs).

2.497 Data Reporting Services Providers (DRSPs) are commercial entities that support investment firms when fulfilling their regulatory reporting obligations. There are three types of DRSPs:

a. Approved publication arrangements (APAs): APAs publish trade reports on behalf of investment firms, which are required to publish information, such as the price and size of executed trades they perform, so that market participants can use it to make informed investment decisions. They are required to publish this information as near to "real time" as possible.

b. Approved Reporting Mechanisms (ARMs): ARMs report details about transactions to the FCA on behalf of investment firms, for market surveillance purposes. This information is not made public.

c. Consolidated tape providers (CTPs): CTPs collate trading data for financial instruments from a variety of sources, including APAs, and consolidate them into a continuous electronic live data stream. This data stream provides price and volume data for each financial instrument and can help market participants to make informed investment decisions.

2.498 A Recognised Investment Exchange (RIE) is a type of trading venue which facilitates the buying and selling of specific financial instruments in a regulated market. Only RIEs can operate UK regulated markets.

**Rationale for Intervention**

2.499 Without legislative intervention, the FCA would not have sufficient power to regulate DRSPs or RIEs once retained EU law is repealed. This would not be appropriate given the importance of DRSPs and RIEs, for the functioning of financial markets.

2.500 Despite retained EU law providing a framework for the regulation of CTPs, no provider has come forward to run a consolidated tape since the relevant legislation was introduced in 2018. This is because a number of legislative barriers have made running a CTP commercially unviable.

2.501 The absence of a consolidated tape means that market participants have to access market data from multiple sources and consolidate it themselves to get an aggregated view of the market. This is costly, time consuming and burdensome which means that some market participants may not be able to access a sufficient level of market data to make informed investment decisions, which may lead to inefficient and unsatisfactory pricing outcomes.

2.502 While there are no CTPs in the UK at present, through the Wholesale Markets Review (WMR) consultation, the government expressed its aim to help facilitate the emergence of a consolidated tape. This was supported by the vast majority of respondents and in its consultation response, the government set out its intention that the FCA should be responsible for setting the requirements for CTPs. This rule-making power will ensure the FCA has the necessary tools to support the emergence of a consolidated tape.

**Policy Objective**

2.503 The objective of the measure is to ensure that the FCA has the necessary rule-making powers to appropriately regulate DRSPs and RIEs once retained EU law has been repealed. This will align the framework for DRSPs and RIEs with other critical pieces of financial market infrastructure to make the UK markets as robust and protected as possible.

2.504 For CTPs specifically, there is also the objective of supporting the emergence of a consolidated tape.

**Description of options considered**

2.505 Option 0 (Do Nothing) – As set out in the FRF Review: Repeal of retained EU law section of this impact assessment, if no action is taken, the regulation of the UK's financial services sector will continue in its current form: a mixture of FSMA regulation, and the EU regulation which was in place at the point of leaving the EU.

2.506 As explained above, while this retained EU law remains in place, the expert regulators are not properly able to carry out the role that Parliament has given them under FSMA and regulate such activities in a way which furthers their statutory objectives, and which is tailored to UK markets and consumers.

2.507 Most rule changes would need to be made by the government via primary legislation, rather than the regulators being able to adapt their rules as they can under the FSMA model. This would place inappropriate and substantial resource pressures on Parliament.

2.508 Option 1 (Preferred Option) – Repeal retained EU law relating to financial services and grant the FCA a general rule-making power in relation to DRSPs and RIEs so that it can set a suitable framework. As set out above, the FCA currently has very limited or no rulemaking powers over DRSPs and RIEs and does not currently have the necessary rule-making powers to replace the retained EU law which applies to these entities once it has been repealed. Furthermore, it does not have the power to appropriately supervise these entities, nor to ensure that the regulatory regime continues to be fit for purpose in the future. Because the activities of these entities

are relied on by financial market participants, this would not be suitable and would leave an important part of financial markets without effective regulation. Moreover, if the Bill does not give the FCA the necessary tools to develop the right framework for a consolidated tape, firms will continue to have to access data from multiple sources which is costly and time consuming.

2.509 This is in line with the position on FMIs that set out in the November FRF Review consultation.

2.510 Given the critical nature of DRSPs and RIEs as an integral part of financial market infrastructure there is no option outside of regulation.

**Outline of preferred policy**

2.511 The Bill gives the FCA a general rule-making power in relation to DRSPs and RIEs. This new power will allow the FCA to replace and, where appropriate, expand the framework in relation to DRSPs and RIEs that is currently set out in EU retained law, but which will no longer be applicable once EU retained law is repealed.

2.512 The power is closely modelled on existing general rule-making powers in FSMA, that the FCA already has in relation to other types of financial services firm.

2.513 The Bill will enable the FCA to use the general rule-making power to make such rules as appear to it to be necessary or expedient for the purpose of advancing one or more of its operational objectives.

2.514 When making rules, the FCA will be subject to the same requirements as it is when exercising its existing general rule-making power in relation to authorised persons. It will be required to consult upon proposed rules, and to accompany this consultation with a cost benefit analysis.

2.515 In its response to the WMR consultation, the government committed to give the FCA the necessary tools to support the emergence of a consolidated tape. Giving a general rule-making power for DRSPs, which includes CTPs, will enable them to remove the firm facing requirements that are currently acting as a barrier to a consolidated tape, and if necessary make further specific changes to support the development of a consolidated tape.

**Methodology**

2.516 The changes proposed through the FRF Review are to the overall framework and will therefore be for the regulators to implement. As such, the costs and benefits of operationalising these measures will be determined by the FCA. However, the government has set out indicative costs for individual measures where this is possible.

2.517 This legislation enables the FCA to set regulatory requirements for DRSPs and RIEs within an appropriate regulatory framework.

2.518 Generally, the benefits of establishing a framework for the regulation of these entities will manifest themselves in the increased agility and adaptability of

regulating them in the longer term, as well as the fact that rules will be made by the independent experts in this area.

2.519 Once the FCA's powers are in place, it may make whatever changes it deems necessary or expedient to the regulatory regime for these firms, as guided by its updated statutory objectives. Any changes would be subject to the usual process of consultation, cost-benefit analysis and engagement with the firms affected, as well as the updated accountability mechanisms provided for in the Bill.

2.520 Generally, the benefits of establishing a framework for the regulation of these entities will manifest themselves in the increased agility and adaptability of regulation in the longer term, as well as the fact that rules will be made by the independent experts in this area.

**Policy Costs**

2.521 This legislation will give the FCA the necessary rulemaking powers that it needs.

2.522 There will be an additional cost to the FCA to the extent to which it decides to make rules for these firms.

**Policy Benefits**

2.523 As the FRF Review measures are designed to deliver a framework for the future, benefits to businesses will be ongoing rather than one-off.

2.524 As is the case for policy costs, the benefits of the policy cannot be quantified at this time as they will be dependent on future decisions made by the FCA, which is operationally independent.

2.525 HM Treasury expects that the new regime should be more agile, responsive and adaptable, with the measure allowing the FCA to quickly and effectively address emerging risks and to ensure that the UK's regulatory regime keeps pace with international standards.

2.526 Supporting the emergence of a consolidated tape would address the issues set out above caused by its absence: it would streamline market participants' access to market data and make it simpler to get an aggregated view of the market. This would reduce costs and administrative burdens, and ensure that they are able to access a sufficient level of market data to make informed investment decisions, leading to efficient pricing.

**Assumptions, limitations, and considerations**

2.527 The impact of rules made by the FCA in comparison to retaining the current rules cannot be predicted at this stage as this will depend on the decisions made by the Bank as part of its full policymaking processes.

2.528 The benefits of the legislation are also similarly dependent on what the rules the FCA will decide to make and therefore cannot be estimated or quantified at this stage.

**Small and MicroBusiness Assessment (SaMBA)**

Number and distribution of businesses in scope of the regulation

2.529 Currently one DRSP (AQ Metrics Ltd) out of seven firms that operate DRPSs[32] and one recognised investment exchange (ISPX) out of six operating in the UK[33] have fewer than 50 employees. The number of RIEs is unlikely to change significantly as industry has indicated that the financial markets are well served by existing RIEs and the number has only moved from 3 to 4 in recent years when a new RIE (ISPX) was authorised to trade property, which was a new asset class. Whilst competition is good for investors too many RIEs make the market fragmented and therefore the government expects the number of RIEs is unlikely to change significantly. Although it is expected that one or more may come forward to operate a consolidated tape (a type of DRSP), as the new rule-making power will give the FCA the ability to remove the barriers that have prevented a consolidated tape provider from emerging. It is unlikely that there will be many new DRSPs however as the existing DRSPs have indicated that, as they operate as utilities, they do not make large revenues from their DRSP businesses.

Do the impacts fall disproportionately on small and microbusinesses?

2.530 The cost for DRSPs and RIEs would be similar regardless of size as they are both regulated entities and are subject to the same parameters. As RIEs and DRSPs operate in a similar way independently of their size, a larger firm would not necessarily absorb the costs more easily than a smaller firm. As for larger firms, the total costs are not possible to quantify at this stage as will depend on how the FCA uses the rulemaking powers granted by the Bill. Any changes to the RIE and DRSPs regulatory framework would be subject to an FCA cost and benefits analysis prior to implementation.

Could small and microbusinesses be exempted while achieving the policy objectives?

2.531 It would not be appropriate to exclude smaller entities from the scope of the new rule-making powers that will be given to the FCA as, regardless of their size, RIEs and DRSPs perform the same function and could pose similar risks to the functioning of financial markets. These risks could be operational, such as a physical halt to a trading platform on an RIE which could result in firms being unable to sell assets. If the market was volatile this could lead to losses for investors that could have been avoided. Similarly, if a DRSP was unable to function and the FCA could not therefore monitor the market, the market could be open to manipulation and investors could be impacted.

Could the impact on small and microbusinesses be mitigated while achieving the policy objectives?

32 https://www.fca.org.uk/markets/data-reporting-services-providers-drsps/authorised-drsps

33 https://register.fca.org.uk/s/search?predefined=RIE

2.532 Because of the critical nature of RIEs and DRSPs as financial market infrastructures in allowing firms to buy and sell securities when they decide to do so to allow them to get the best outcomes for such firms, and because of the importance of reporting of firms' trades so that the regulator can monitor the markets to ensure there is no market abuse by firms, all RIEs and DRSP's need to be regulated in such a way that upholds orderly, robust financial markets. This means that that the policy objectives would not be achieved by reducing the impact on small and microbusinesses.

Wider impacts on small and microbusinesses

2.533 RIEs and DRSPs affect firms that act the financial markets directly and affect others indirectly by upholding the financial markets that in turn support the real economy and retail investors. Investment firms may interact directly with RIEs and DRSPs or indirectly using third parties. For example, a fund manager may use an investment firm or broker to access an RIE and to report its trades to a DRSP but the beneficiaries of the pension fund may be individuals who utilise the fund manager for his or her retirement pension or savings plan. Individuals will be impacted by any failure of FMIs as FMIs are at the heart of insurance, savings, and the growth of the economy – for example a local authority or the government will use RIEs to invest for future, a public company will have its shares listed on an RIE in order to grow and pay dividends to its shareholders.

## FRF Review Case Studies: Prospectus Review

2.534 These chase studies have been provided to demonstrate how the FRF Review powers may be used in future. They are intended to be illustrative only.

**Case study – listings and prospectus regulation**

2.535 In November 2020, the Chancellor asked Lord Hill of Oareford CBE to examine how the UK's listing regime could be reformed. The objective of Lord Hill's review was to propose reforms to attract the most innovative and successful firms to list in the UK and help companies access the finance they need to grow.

2.536 Under the existing UK public offer regime, a public offer of securities cannot be made, and securities cannot be admitted to regulated markets, unless the offer/admission benefits from an exemption or a prospectus is published. Prospectuses are a key piece of the regulatory framework in most developed capital markets, albeit the name might vary from place to place. A prospectus is the document in which a company seeking admission to a stock market or raising fresh capital or finance through the issuance of new securities sets out, for the benefit of investors, the information those investors need to make informed investment decisions. The requirement for a prospectus aims to ensure that all investors receive adequate and accurate information, to be able to make decisions based on the information set out in the prospectus. Where material facts are omitted or where information is misleading or inaccurate, those responsible for the prospectus may be held liable for loss suffered by investors.

2.537 UK regulation in this area is largely contained in Part VI (sections 73A-103) of FSMA and in the UK Prospectus Regulation, a piece of retained EU law which entered into force on 20 July 2017 and has applied in full since 21 July 2019.

2.538 Lord Hill argued that the current regime is duplicative, making the public capital raising process inefficient and disincentivising the use of public markets or the inclusion of retail investors in public offers. As the current regime sets out detailed and prescriptive rules in primary legislation, it is inflexible and unresponsive to changing market conditions.

2.539 Lord Hill's UK Listing Review[34] made a number of recommendations, of which three relate to this regime. These were:

a. **Recommendation 7:** HM Treasury should conduct a fundamental review of the UK's Prospectus Regime, so that it fits better with both the breadth and maturity of UK capital markets and the evolution in the types of businesses coming to market as well as those that are already listed. Lord Hill argued that consideration should be given, as a minimum, to the following areas:

    - changing prospectus requirements so that in future, admission to a regulated market and offers to the public are treated separately;

[34] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/966133/UK_Listing_Review_3_March.pdf

- changing how the prospectus exemption thresholds function so that documentation is only required where it is appropriate for the type of transaction being undertaken and suits the circumstances of capital issuance;
- use of alternative listing documentation where appropriate and possible, e.g. in the event of further issuance by an existing listed issuer on a regulated market.

b. **Recommendation 8:** Maintain the existing regime within the Listing Rules for secondary and dual listing. As part of the review of the Prospectus Regime, consider whether prospectuses drawn up under other jurisdictions' rules can be used to meet UK requirements.

c. **Recommendation 9:** Facilitate the provision of forward-looking information by issuers in prospectuses, by amending the liability regime for issuers and their directors.

2.540 In response to Lord Hill's recommendations, the government launched a consultation[35] on reforms to the UK's Prospectus Regime in July 2021. The consultation closed in September 2021 and HMT published the outcome36 in March 2022.

2.541 In this, the government confirmed that it will repeal and replace the regime currently contained in the UK Prospectus Regulation. Core to the reform will be removing duplication within the regime and simplifying regulation. The current regime brings together two different regulatory concerns – the regulation of public offers of securities, and the regulation of admissions to specified stock markets – which should be dealt with separately so that they can be addressed on their individual merits. The existing approach makes the capital raising process inefficient and disincentivises companies from raising capital from retail investors. These reforms will therefore separate out these two issues, as Lord Hill recommended. Further, it intends to make the regime more agile, flexible and responsive. The government is concerned about embedding the level of detail that is in the current UK Prospectus Regulation into legislation. Our goal is that regulation in this area should be more agile and dynamic. HM Treasury therefore intend to delegate to the FCA a greater degree of responsibility to set out the detail of the new regime in FCA rules while also ensuring the FCA has powers to oversee and police the new framework.

2.542 These reforms will be delivered using the powers included in this Bill to implement the outcomes of the FRF Review. The UK Prospectus Regulation and ancillary legislation will be repealed, and the powers contained in the Bill will be used to put in place new regulation made by HMT to establish the legislative framework for the new rules to be made by the FCA. Giving more responsibility to the FCA, while maintaining oversight of HM Treasury and Parliament, will ensure that the FCA can

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[35] https://www.gov.uk/government/consultations/uk-prospectus-regime-a-consultation

[36] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1058438/UK_Prospectus_Regime_Review_Outcome.pdf

make the rules that it, as an expert regulator, considers most appropriate, in line with its general duties and any applicable "have regards" that Parliament has set it. It will also enable rules to be more responsive to significant changes in the market, as the FCA is generally not tied to legislative timelines and can update its rules following an appropriate consultation and complying with its general duties when making rules under FSMA.

2.543 This Bill creates the framework that will enable the changes to the public offer regime, but subsequent secondary legislation and rules will be required to deliver them. This case study is therefore provided as an illustrative example of the types of changes that the FRF Review legislation will enable secondary legislation to deliver.

2.544 Under this approach, the full suite of reforms to the UK's public offer regime will take effect after the FCA has consulted on, and is ready to implement, new rules under its expanded responsibilities. FCA consultation will be accompanied by a cost benefit analysis under the applicable CBA procedure.

**Outline of proposed policy**

2.545 While the FCA will be able to require a prospectus for admissions to trading on Regulated Markets (such as the Main Market of the London Stock Exchange), prospectuses will not be a feature of the public offer regime. In the new system, there will be a general prohibition on offering securities to the public, against which there will be exemptions. These exemptions will be derived from existing exemptions in the Prospectus Regulation but will be expanded to cover other offerings of securities, including those which are, or will be, admitted to UK Regulated Markets.

2.546 The government intends to give the FCA enhanced rule-making responsibilities regarding admissions of securities to trading on UK Regulated Markets. These enhanced responsibilities will allow the FCA to specify in its rulebook when a prospectus is required to be published, including on a further issuance by an existing listed issuer. The FCA will also be able to make rules determining what information should be included in a prospectus and when and how it should be published. The FCA's enhanced responsibilities will give it enough flexibility to determine whether to require a UK prospectus for admission by an overseas listed issuer. Furthermore, the reformed regime will give the FCA the discretion to decide whether – and, if so, in which circumstances – prospectuses must be reviewed and approved by it prior to publication.

2.547 Thresholds stated in Euros in the Prospectus Regulation will be re-stated into sterling at 1 for 1. However, to minimise disruption to UK institutional investor access to international wholesale bond markets, the government intends to change the current €100,000 threshold exemption for offers of wholesale non-equity securities to £50,000.

2.548 The government will maintain the right of companies to offer securities to the public without admitting them to a stock market, and wishes to increase the capital raising options available to unlisted companies, enabling them to grow their businesses quicker. As such, the government intends to remove the current requirement for an

FCA-approved prospectus on offers over €8million in size to be published. Instead, securities will be allowed to be offered to the public provided the offer is made through a platform operated by a firm specifically authorised for this purpose.

2.549 To deliver this, the government intends to create a new regulated activity covering the operation of an electronic platform for the public offering of in-scope securities. It is likely that existing securities-based crowdfunding platforms would be carrying on this activity. The FCA will have the power to determine the detailed requirements to which such platforms will be subject.

**Methodology**

2.550 All firms that are currently involved in offering securities will be affected by these changes. This includes amongst others:

a. Trading venues – There are six recognised investment exchanges (RIEs) that are recognised by the FCA. These changes will impact three: London Stock Exchange, Aquis Exchange and ISPX.

b. Crowdfunding platforms – there are 16 firms that are members of the UK Crowdfunding Association.

c. Brokers, investment banks and other advisory firms – HM Treasury is unable to estimate the number of advisory firms.

d. Retail and institutional investors – HM Treasury is unable to estimate the number of retail and institutional investors. In theory, the number of retail investors could be everyone in the UK over the age of 18.

e. Issuers/potential issuers – there are 1,300 companies listed on the London Stock Exchange's Main Market, 821 on the Alternative Investment Market and 90 on Aquis. Private companies who are considering going public, or have started the process of doing so, will have to comply with the new regime (depending on timing). It's not possible to estimate this figure.

2.551 Exactly how these firms will be affected will be determined by the SI framework and future rules made by the FCA. The latter will be subject to a thorough cost benefit analysis by the FCA.

**Policy Costs**

2.552 Trading venues, crowdfunding platforms, brokers, investment banks and other advisory firms, institutional investors and issuers or potential issues will have to familiarise themselves with the legislative changes. It is possible that more than one person per firm will have to familiarise themselves with the changes. For example, some firms may organise training sessions, or disseminate information about the changes internally to ensure that employees understand them.

Authorisation of crowdfunding platforms

2.553 Creating a new regulated activity covering the operation of an electronic platform for the public offering of in-scope securities will impose a cost on crowdfunding platforms who wish to apply for this permission.

2.554 Firms will incur the cost of applying for authorisation or a variation of their existing permissions (costs for this regime are to be decided following FCA consultation) and will also incur legal and preparation fees. Crowdfunding platforms and other platform operators carrying on a business subject any new FCA rules will also incur ongoing costs of compliance with new rules. However, to the extent firms are already authorised and subject to general rules for investment activities (i.e. existing crowdfunding activity that is already subject to regulation), the baseline will be that of existing compliance with FCA rules, against which any new standards will represent incremental costs (if the FCA creates new requirements).

**Policy Benefits**

2.555 As noted above, the UK Prospectus Regime will be simplified and the unnecessary duplication will be removed.

2.556 There are few reliable estimates of the cost of producing a prospectus. Respondents to the Government's 2010 Green Paper consultation, Financing a Private Sector Recovery, estimated the cost of producing a prospectus for deals below £10 million as between 7 to 12 per cent of the funds raised.[37] This is the most recent analysis identified. However, the figure for larger capital raises on Regulated Markets is likely to be far lower, with the cost of producing a prospectus constituting a smaller percentage of capital raised.

2.557 There is no available record showing the total amount of capital raised by issuances of securities that involved the publication of an FCA approved prospectus. However, all issuances on the Main Market of the London Stock Exchange can be used as a proxy for issuances that involved the publication of a prospectus (in reality, not every issuance on the Main Market requires a prospectus). Between 2011-2020, there were 5699 issuances on the Main Market, raising a total of £141bn. If the SI and rules were able to deliver even a small reduction in costs faced by issuers then this would have a significant benefit to the market.

2.558 This example is provided for illustrative purposes only at this stage and it will be for the FCA to develop the details of the future rules.

Benefits to investors

2.559 The proposed changes aim to improve the functioning of the market overall and to encourage a broader cross-section of society to invest in and benefit from the growth of relevant companies. It will also give the FCA greater scope to tailor

[37] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/253760/bis-10-1081-financing-private-sector-recovery.pdf

requirements to ensure investors have the most useful information to inform their investment decisions.

**Small and Microbusiness Assessment (SaMBA)**

2.560 This regulation is unlikely to have a significant cost to small and microbusinesses. At present, companies conducting a capital raise of less than €8 million are exempt from the requirement to prepare a prospectus. Companies raising capital above this threshold are larger and would not be considered small or microbusinesses.

2.561 The government intends to retain a threshold (restated in sterling) below which companies are exempt from the regime. While this may be lower than the existing €8 million threshold, small and microbusinesses will continue to be able to use this exemption. An exemption will also exist for charities.

## FRF Review Case Studies – “Strong and simple” prudential framework

2.562 The PRA regulates a diverse range of banks and building societies in the UK, from some of the largest banks in the world who are globally active and systemically important, to small challenger banks. Currently, it applies broadly the same prudential regime to all of them. As set out by the Bank of England (Bank) in its Discussion Paper on this issue, this means smaller banks and building societies may face prudential requirements that go beyond what is actually needed to ensure their safety and soundness. This may impose unnecessary costs on these banks and building societies, and reduce effective competition in the UK banking sector.

2.563 Implementing the outcomes of the FRF Review will give the PRA responsibility for determining the appropriate prudential rules for banks and building societies, in line with their statutory objectives set by Parliament. Currently, these rules sit in the Capital Requirements Regulation (CRR), part of retained EU law. While the Financial Services Act 2021 gave HM Treasury the power to repeal parts of CRR, in a way that is consistent with the broader approach taken in the FRF Review, large parts of it still cannot be amended or repealed.

2.564 Repealing CRR and giving the PRA responsibility for determining prudential requirements for banks and building societies will enable the PRA to make the changes that it considers appropriate. It is consulting on a “strong and simple” prudential framework that would apply to banks and building societies that are not systemically important or globally active.

2.565 The PRA has set out that it wants “to avoid the inadvertent creation of new barriers to growth…to implement a framework that supports a dynamic and diverse banking sector in the UK, in which successful banks and building societies can grow and less successful ones can contract and exit in an orderly fashion”, while maintaining the resilience of smaller banks and building societies. These aims are guided by its statutory objectives.

2.566 The PRA’s Consultation Paper sets out its proposals for reform, and includes a cost benefit analysis. That estimates that 61 firms would be subject to the “strong and simple” framework that is proposed, rather than the more complex regime that currently applies to them. The paper sets out the PRA’s expectation that its future simpler regime should make prudential rules simpler for firms that it applies to. This could reduce costs faced by such firms, which should increase their resilience. It could also encourage greater entry into the UK banking sector, increasing competition. The PRA considers that to determine whether it would be subject to the new regime, a firm would need to undertake its own analysis based on the proposed scope criteria. Firms may incur additional costs as a result. However, the PRA does not consider there would be significant additional costs for firms, because the PRA has sought as far as possible to use existing definitions and measures in the design.

2.567 The PRA is already required to undertake a cost benefit analysis when proposing new rules. Following the implementation of the FRF Review outcomes, the PRA will be required to establish and maintain a statutory panel which is dedicated to supporting the development of the PRA’s cost benefit analyses. This should further

support the quality of future cost benefit analyses, helping to ensure that they are based on the best available evidence and underpinned by robust analysis.

## FRF Review: Monitoring and Evaluation

2.568 In line with the general requirement, HM Treasury will submit to the Treasury Select Committee, within three to five years of Royal Assent, a preliminary assessment of how the Act has worked in practice, relative to objectives and benchmarks identified during the passage of the Bill and in the supporting documentation. The FRF Review measures will be considered as part of this post-legislative memorandum.

2.569 Where it is necessary to amend or revoke retained EU law under the empowerments in this Bill, this will be subject to the normal Impact Assessment process for secondary legislation.

2.570 Where the Bill requires regulators to exercise their rule-making powers, they are required by statute to conduct a cost-benefit analysis of their rule proposals, with no de minimis exemption. There are exemptions for a small number of specific rules, such as increasing their fees. Under the Small Business, Enterprise, and Employment Act 2015, the FCA is also required to conduct an impact assessment and submit it to the RPC for policies that cross the de minimis threshold set by the Secretary of State.

2.571 Similarly, when exercising its rule-making powers under FSMA, including the new powers granted in this legislation, the Bank must comply with various provisions of Part 9A FSMA (as set out in paragraph 10 of Schedule 17A FSMA) including on consultation and cost benefit analysis.

2.572 In their annual reports to HM Treasury, the regulators are required to report on the extent to which their objectives have been advanced and their consideration of the regulatory principles. In addition to publishing these reports, the regulators are required to invite representations on them, including on how they have advanced their objectives. The regulators' assessments of their own actions will support HM Treasury and Parliament's scrutiny of the effectiveness of the measures.

2.573 Over time, the regulators would be expected to update their public frameworks for rule review and CBA, which seek to systematise this monitoring and evaluation. As they do so, they will take into account representations by the public and their CBA panels on how the frameworks have performed so far. Updates to the frameworks will therefore provide an opportunity to assess their effectiveness so far. The reviews themselves will also provide an assessment of their effectiveness.

2.574 The Parliamentary measures are, appropriately, for Parliament to determine the effectiveness of. These sources of information will also provide Parliament with information on which to base further scrutiny of the measures' effectiveness.

# An open and global financial hub

## Implementation of Mutual Recognition Agreements

**Problem under consideration**

3.1 The government is committed to building on the UK's strengths as a global financial hub by enhancing its relationships with overseas partners. A key aspect of this is to agree, where applicable, Mutual Recognition Agreements (MRAs) in the area of financial services with jurisdictions around the world. MRAs offer a practical way to promote openness and mutual market access between jurisdictions, supported by regulatory and supervisory cooperation. Mutual recognition, in a broad sense, means that services produced under one regulatory framework or set of rules in nation A enjoy market access in country B, which has different rules. This reduces costs and regulatory barriers for firms from country A accessing country B's market, and vice versa.

3.2 Outside of the EU, the UK is able to form its own international agreements, including MRAs that will benefit UK firms and businesses. The Chancellor of the Exchequer and the Swiss Federal Councillor committed in June 2020 to negotiate a comprehensive agreement to improve the cross-border market for financial services between the UK and Switzerland, covering the provision of services to wholesale and sophisticated clients in the fields of insurance, banking, asset management and capital markets (including market infrastructure). These negotiations are ongoing and expected to conclude by the end of 2022. The UK also has ambitions to negotiate MRAs with other countries in future.

3.3 In order to give effect to specific MRAs which the government negotiates, it will be necessary to use legislation to amend the way that the UK's financial services regulation applies to firms operating in the MRA jurisdiction, or to disapply it in some areas. This will require amendments to existing financial services legislation and may also require the financial services regulators to have additional powers. The government's intention is for MRAs to be 'living agreements', with the potential to evolve over time. Furthermore, it is important that the government has the flexibility to be able to implement MRAs so as to promote trade opportunities and ensure that domestic legislation does not come into conflict with MRA commitments in international law. This being the case the government needs a mechanism for implementing MRAs in a timely way, ensuring that the UK can fulfil international treaty commitments.

3.4 The domestic implementation of the agreement is separate from, and additional to, the process for parliamentary scrutiny of treaties set out in the Constitutional Reform and Governance ('CRAG') Act 2010. Under the CRAG procedure, the government is required to lay copies of signed treaties before Parliament before they are ratified, providing Parliament with the opportunity at that stage to give its view on the detailed contents of the treaty and whether it should become binding in the UK.

**Rationale for intervention**

3.5 As set out above, international treaties such as MRAs must be implemented into domestic law. To do so, it is likely to be necessary to amend both existing primary and secondary legislation.

3.6 The government, therefore, requires the ability to amend legislation for the purposes of implementing both the UK-Switzerland MRA and MRAs agreed in the future. By taking a power to do this via secondary legislation, this will ensure that primary legislation will not be needed for each individual MRA, as this could delay ratification and make it more difficult for the UK to deliver on its international obligations.

3.7 At the point of secondary legislation, and in line with the government's approach to better regulation under the Better Regulation Framework, HM Treasury will make efforts to further consult on and understand the potential further impacts of this measure, including through appropriate stakeholder engagement. More detailed qualitative and quantitative cost-benefit analyses are expected to be covered in the IAs accompanying the relevant secondary legislation enabled by the Bill. HM Treasury will also engage with the RPC, prior to the submission of IAs produced to accompany future secondary legislation where appropriate.

**Policy Objective**

3.8 The objective is to ensure that the government can implement the MRAs it negotiates by making necessary adjustments to financial services legislation.

3.9 An MRA could provide for streamlined application processes for certain licences, permit the cross-border provision of certain services where it is not currently possible, or enable greater information sharing between governments to strengthen protection against financial stability risks.

3.10 The government will also need to have the ability to grant any additional powers to, or impose any additional duties on, the financial services regulators as necessary for them to implement negotiated MRAs.

**Description of Options Considered**

3.11 Option 0 (Do nothing) - without a delivery mechanism to implement MRAs, the government risks not having the means to fully implement the terms of the UK-Switzerland MRA or any future MRAs in a timely way. This would prevent the UK from ratifying the UK-Switzerland MRA until it has brought forward primary legislation, significantly delaying ratification.

3.12 Extended delays to the implementation of the UK-Switzerland MRA would delay the potential use of the UK-Switzerland MRA by UK and Swiss firms and could harm the UK's diplomatic relationship with Switzerland. Additionally, delays could make other countries less likely to want to negotiate MRAs with the UK in future.

3.13 For future MRAs, this option would mean that further primary legislation would be required each time a MRA is agreed, which could risk the timely implementation and ratification of these agreements and make them a less effective trade policy tool, limiting the benefits to UK businesses that the MRAs are designed to harness.

3.14 Option 1 (Preferred Option) - use primary legislation to create an implementation power, that will enable HM Treasury to make changes to legislation via secondary legislation for the specific purpose of implementing MRAs, including the UK-Switzerland MRA. This option ensures that the obligations to which the UK commits can be met in its domestic law, and where there are any gaps, it ensures there is a mechanism to adjust existing legislation to permit the level of market access and other commitments agreed via the international treaty. Under this option, there will be Parliamentary scrutiny via existing procedures, for example, the CRAG process and scrutiny of statutory instruments as well as scrutiny measures associated with the use of the power itself.

3.15 This option best meets the policy objectives to ensure the UK delivers on its commitments in the MRA and provides continuity and certainty for partner countries, as well as UK and overseas firms. It will also allow the government to update the agreement in the future where necessary, as new areas emerge (for example, if a new market arose in a developing sector such as FinTech that either party may want to include in the MRA in future years), or to promptly make necessary changes in UK law in cases where recognition needs to be withdrawn.

**Outline of preferred policy**

3.16 The Bill will give HM Treasury a power to make changes to legislation for the purpose of implementing MRAs. The power will:

a. Enable HM Treasury to amend, delete or replace legislation and regulator rules to give effect to an MRA.

b. Allow HM Treasury to provide relevant powers for, or impose duties upon, the financial services regulators (the Bank of England (Bank), the PRA and the FCA) in relation to the implementation of MRAs. The legislation ensures the financial services regulators have the appropriate powers to implement the obligations agreed under MRAs and to ensure that UK firms are able to access its benefits. This will include ensuring that the regulators have the appropriate tools to take action where firms breach the relevant rules.

c. Allow HM Treasury to introduce any appropriate regulatory safeguards, including allowing for the revocation of implementing legislation where recognition is withdrawn under an MRA.

d. Provide for a mechanism to give effect to the agreement. MRAs are likely to include decision-making processes such as a joint committee which will allow the parties to extend the MRA or otherwise amend its effects. The legislation will enable decisions taken under such a joint committee to be implemented, including allowing for any modifications or changes to arrangements under the MRA and provide for possible future extension of the MRA to new areas of market access.

e. Provide mechanisms for implementing decisions taken as part of the anticipated arbitration/dispute resolution measures of the agreement. The legislation enables HM Treasury to implement any changes required as a result of negotiations, mediation or arbitration process following a dispute under an MRA.

3.17 Taken together, these will enable the implementation of MRAs and ensure that there is a mechanism for the UK to meet its obligations as agreed through the MRA and to give effect to its terms in domestic law. It also ensures that, where an MRA goes further than existing domestic arrangements in terms of market access or other commitments, there will be a mechanism to adjust legislation to give effect to the international treaty.

3.18 When implementing each negotiated MRA via secondary legislation under these powers, the appropriate processes will be followed including the production of an Impact Assessment. The secondary legislation will be subject to the affirmative procedure, meaning that it will be debated by Parliament before taking effect.

3.19 As with most international treaties, any MRAs for financial services made in the future will be subject to parliamentary scrutiny before ratification as set out in the Constitutional Reform and Governance Act 2010 (CRAG). As part of the process, the government will set out in the explanatory memorandum accompanying any MRA how it intends to implement its terms in domestic law. Only once an MRA has both been scrutinised by Parliament pursuant to the CRAG process and all necessary domestic implementation has been completed will an MRA be ratified and enter into force.

3.20 This legislation will enable the UK to implement future MRAs and ensure that it provides the UK with the flexibility to efficiently and effectively implement the outcomes as agreed through an MRA. This is important because as an independent sovereign nation, the UK has the opportunity to shape and develop its ambitions for financial services, particularly the way this interacts with other jurisdictions (e.g. Switzerland). Ensuring that these agreements are implemented efficiently is important to ensure that the UK is delivering its international obligations and avoid any reputational issues that may arise as a result of a delay or failure to implement an agreement.

**Methodology**

3.21 The legislation is an enabling power that will allow MRAs to be implemented in domestic law in the UK once they are agreed. As a result, the legislation itself will not directly lead to new costs or benefits, relative to the counterfactual of not taking such a power. Any potential costs and benefits associated with the use of these provisions in the future will be assessed as part of the secondary legislation that will implement the UK-Switzerland MRA, and any future MRAs that the UK will sign.

3.22 However, it is possible to provide an indication of possible costs and benefits of MRAs, whose delivery will be supported by this power.

3.23 Further details will be set out in the secondary legislation that is enabled by the Bill. HM Treasury will provide a further impact assessment in each instance of a where it

makes such secondary legislation. However, to inform an assessment of the bill the government has set out the possible costs and benefits. It is important to note, however, that the below costs and benefits are illustrative and any costs and benefits to firms will be contingent on the exact nature of the secondary legislation. This measure will not result in direct costs or benefits to business.

3.24 At the point of secondary legislation, and in line with the government's approach to better regulation under the Better Regulation Framework, HM Treasury will make efforts to further consult on and understand the potential further impacts of this measure, including through appropriate stakeholder engagement. More detailed qualitative and quantitative cost-benefit analyses are expected to be covered in the IAs accompanying the relevant secondary legislation enabled by the Bill. HM Treasury will also engage with the RPC, prior to the submission of IAs produced to accompany future secondary legislation where appropriate.

**Policy Costs**

3.25 The main purpose of MRAs is to facilitate common improvements in the cross-border trade of goods and services. Economic gains, particularly through greater trade flows, are driving the benefits associated with MRAs. The impact of MRAs on trade, enabled by decreased market access costs, has been found to be beneficial in some empirical economic literature.

3.26 However, the literature notes that mutual recognition can lead to information, transaction, and compliance costs[38] (e.g. through internal familiarisation), which will vary between goods and services. Once an MRA has been agreed, any firm which chooses to perform cross-border activity with the partner jurisdiction, as facilitated by the MRA, would need to invest resources in understanding the national standards and regulations in the partner country. Firms would do this after weighing up the costs and potential benefits of performing the cross-border activity. These costs would vary across different types of services and could lead to the altering of the competitive exposure of domestic firms, depending on the specifics of the MRA being implemented, and would arise as a result of the commitments in the MRA, rather than through the exercise of this power.

**Policy Benefits**

3.27 This MRA implementation power does not have any direct benefits in and of itself. This is because the implementation power only acts as a mechanism by which MRAs can be delivered in future.

3.28 However, having a clear delivery mechanism to implement future agreements is a prerequisite for the ratification of any future agreements, as this is a requirement of CRAG. As such, it is possible to state that this power will present some possible benefits in the future, by demonstrating to potential international partners that UK has the ability to quickly and effectively give effect to such agreements, which is

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[38] http://aei.pitt.edu/1852/1/ENEPRI_WP16.pdf

understood to be the case with Switzerland and, potentially, other MRA partners in the future.

3.29 MRAs will be agreed by the UK government in order to facilitate and reap potential economic benefits. In order to deliver these ambitious agreements, the delivery mechanism must also be efficient. This power will give the government the opportunity to efficiently deliver MRAs in a timely manner for financial services. Without the power, it is feasible that the government would need to bring forward primary legislation for every MRA agreed in the future. This would risk delaying the implementation of the MRA, and the associated related to market access.

3.30 An OECD report notes[39] there are expected economic gains from MRAs. Benefits arise from lowering the costs to UK businesses of testing and certification when they export products, reducing the overall cost of complying with trading partners' technical requirements.

3.31 Furthermore, the report discusses that some evidence have shown there was an increase in the volume of trade brought about through increased cooperation between countries following the implementation of MRAs, although the size of the impact varies depending on several variables, including the existing level of trade and the other party to the agreement. Higher regulatory cooperation is argued to improve administration efficiency and enhance knowledge sharing between regulators – potentially improving the efficiency of regulation, which will minimise the future burdens on firms.

3.32 One of the overarching benefits of MRAs is that they are likely to confer benefits through lower transaction costs for businesses trading and the subsequent economic benefits associated with this e.g. greater trade and profits for businesses; lower costs for consumers; potentially higher efficiency for businesses. This is because the negotiation of cross-border access has been agreed between two jurisdictions to facilitate easier/better access compared to other jurisdictions that are not subject to an MRA.

**Assumptions, limitations, and considerations**

3.33 The Bill will put in place powers that will allow HM Treasury to implement MRAs efficiently and in a way that does not require significant volumes of legislation for each MRA which is negotiated.

3.34 Most of the impacts cannot be accurately appraised at this stage because they are dependent on negotiations with overseas jurisdictions and the content of any secondary legislation. More detailed impact assessments will be developed at the implementation stage of any secondary legislation. However, broadly, MRAs will bring the benefit of increased cooperation between the UK and MRA partners, providing firms with a more stable and transparent relationship on which to base their cross-border activity.

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[39] https://www.oecd.org/regreform/WP2_Contribution-of-mutual-recognition-to-IRC.pdf

**Small and MicroBusiness Assessment (SaMBA)**

Number and distribution of businesses in scope of the regulation

3.35 This measure does not directly impact small or microbusinesses. As outlined, this measure is designed to provide the government with a power to implement Mutual Recognition Agreements in a way that is efficient, with the specific impacts of an MRA to be outlined in future impact assessments at the point of implementing via secondary legislation. Any direct costs of benefits to firms will arise as a result of future MRAs, rather than this implementing legislation. The statutory instruments that will be laid using these powers to implement specific, negotiated MRAs will be accompanied by additional impact assessments that will include any specific costs dependent on the scope of the MRA negotiated with a partner jurisdiction.

3.36 The PRA currently regulates 1432 financial services firms, including 409 Credit Unions, 371 Capital Requirements Regulation (CRR) firms and 652 insurers. All 409 Credit Unions (100 per cent) can be classified as SMBs (firms with less than 50 employees). The PRA did not have data on employee size for all CCR and insurance firms. However, using a threshold of turnover of less than £10.2 million the PRA estimate 25 CRR firms are SMBs (6.74 per cent) and at least 328 insurers are SMBs (50.3 per cent).

3.37 Similarly, the FCA currently regulates over 50,000 firms. The FCA does not hold comprehensive data on the number of employees in these firms. Not all FCA regulated firms are required to report data to the FCA, and so only 38,599 out of the 50,000 firms regulated by the FCA have submitted turnover data for the 2021 financial end. Out of these 38,599 reporting firms, 34,533 (89%) can be classified as 'small' (turnover of less than or equal to £10.2 million). This data is based on the 2021 financial end for FCA regulated firms with an active status and where the data is stored and accessible from the FCA’s data lake. It does not cover data reported by firms who no longer have an active status. Where there are gaps, the FCA have looked to try to fill these using information from a survey conducted in response to the COVID-19 situation, though it should be noted that not all firms completed this. Using 89% as a proxy, HM Treasury estimates that approximately 44,500 SMBs are currently regulated by the FCA.

3.38 As this measure is designed to implement mutual recognition agreements, which could be subject to significant variation, it is not possible to quantify any impact on small and micro businesses at this stage. Following the negotiation of an MRA, the government would use this power to pass secondary legislation to implement it, and this would be accompanied by an impact assessment that considered the costs and benefits of the specific MRA that has been negotiated.

Do the impacts fall disproportionately on small and microbusinesses?

3.39 This is enabling legislation which has no direct impact on firms, including SMBs. Therefore, there are no direct impacts associated with the enabling legislation in the Bill, and therefore no disproportionate impacts on SMBs.

3.40 The measure indirectly benefits financial services firms in the UK who engage in cross-border activity. By supporting the delivery of future MRAs, such firms are expected to benefit from increased efficiency and enhanced cooperation between the UK regulators and other jurisdictions, in the event that an MRA is agreed in future.

3.41 Small and micro-businesses can also benefit from this. It may be possible that costs could arise as a result, for example, through greater competition, however, this would depend on the specific MRA agreed between jurisdictions.

3.42 It is expected that the scope of an MRA could cover a wide range of sectors, such as insurance, banking, asset management and capital markets, including market infrastructure. Whether certain types of businesses are disproportionately affected will depend on the sectoral impact of each negotiated individual agreement and the specific trade barriers that are reduced in these agreements. This could depend on a number of factors, for example:

a. The relative comparative advantage of the partner country; and

b. The significance of the preferential arrangements on market dynamics

3.43 The specific impacts associated with an MRA on Small and Micro Businesses will be considered in future impact assessments that will be required in order to implement an MRA via secondary legislation.

Could small and microbusinesses be exempted while achieving the policy objectives?

3.44 This measure provides the government with a mechanism to implement MRAs. As there is no direct impact on firms, the government does not consider it necessary or appropriate to exempt SMBs. Exempting SMBs at this stage could prevent them from benefiting from any future MRAs firms, which are expected to benefit firms by providing a more stable and transparent relationship on which to base their cross-border activity.

Could the impact on small and microbusinesses be mitigated while achieving the policy objectives?

3.45 As this is an enabling measure, there is no direct impact on SMBs, and therefore the government does not consider that mitigation is necessary or appropriate. Any suitable potential mitigations for SMBs would be considered as part of the process of negotiating a specific MRA and would therefore be covered in the future impact assessment for the secondary legislation that implements the specific MRA.

Wider impacts on small and microbusinesses

3.46 This measure supports the adoption of MRAs in future. MRAs will bring the benefit of increased cooperation between the UK and MRA partners, providing financial services firms with a more stable and transparent relationship on which to base their cross-border activity.

## Amendments to the EU Securitisation Regulation 2017

**Problem under consideration**

4.1 Securitisation is the process of pooling various financial exposures (such as mortgages, auto loans, or consumer loans) to create a financial instrument that can be marketed to investors. These financial instruments are 'tranched', which means that they carry different levels of risk and return to suit the appetite of different investors. This process allows lenders (such as banks) to transfer the risks of loans or assets to other banks or investors (such as insurance firms or asset managers). This can help free up lenders' balance sheets to allow for further lending to the economy.

4.2 Securitisation is an important part of well-functioning markets and a useful source of finance for UK businesses. In addition to helping free up lenders' balance sheets, it can diversify funding sources and allow for a broader distribution of financial-sector risk. Overall, it can make the financial system more efficient and provide additional investment opportunities. Although securitisation is considered by some to have played a role in the global financial crisis (GFC), the Securitisation Regulation, which is retained EU law in the UK, introduced reforms in the UK and EU following the GFC, including stricter standards in terms of alignment of interests, disclosures, and investor due diligence.

4.3 Under the UK Securitisation Regulation, certain securitisations can be designated as Simple, Transparent and Standardised (STS). Such STS securitisations are designed to make it easier for investors to understand and assess the risks of a securitisation investment by excluding more complex features. The UK STS framework is in line with international standards for Simple, Transparent, and Comparable (STC) securitisation, set by the Basel Committee on Banking Supervision (BCBS) and International Organization of Securities Commissions (IOSCO).

4.4 Some firms who invest in securitisation (in particular banks, building societies, investment firms and insurance firms) are subject to prudential regulation. Prudential regulation seeks to ensure that financial institutions have adequate financial resources and risk management processes so they can continue to provide vital services to the real economy throughout economic and financial cycles. Banks, building societies, and PRA-designated investment firms are subject to prudential requirements in the Capital Requirements Regulation and relevant PRA rules (these will be referred to as 'CRR firms'), and some insurance firms are subject to prudential requirements under the Solvency II regime (these will be referred to as 'Solvency II firms'). These two regimes require firms to hold capital against their exposures, including exposures to securitisations, dependent on the risk attached to them.

4.5 CRR firms and Solvency II firms who invest in STS securitisations can benefit from preferential capital treatment for these investments, compared to investing in non-STS securitisations. Preferential treatment means they can be eligible for lower requirements than other securitisations, reflecting their adherence to simple, transparent, and standardised criteria.

4.6 Currently, in order for a securitisation to be designated as STS, the UK Securitisation Regulation specifies that the originator[40] and sponsor[41] (or for Asset-Backed Commercial Paper (ABCP) securitisations,[42] just the sponsor) of a securitisation must be established in the UK. In addition, STS securitisations designated under the EU Securitisation Regulation (with the originator and sponsor in the EU) before 31 December 2022 are also recognised as STS in the UK for the lifetime of the securitisation.

4.7 Therefore, securitisations with originators and sponsors established outside the UK (or outside the EU after 31 December 2022) cannot be designated as STS, and CRR firms and Solvency II firms cannot get preferential capital treatment for investing in those securitisations, even if this is appropriate to reflect their adherence to STS criteria.

4.8 This means that CRR firms and Solvency II firms are not able to receive appropriate capital treatment for STS securitisations issued by non-UK entities (or non-EU entities after 31 December 2022). This limits the availability of STS securitisations for UK investors.

**Rationale for intervention**

4.9 The government supports the development of sound securitisation markets, including the growth of the STS securitisation market. To support HM Treasury's legally mandated review of the UK Securitisation Regulation,[43] HM Treasury issued a call for evidence to gather views on the desirability of an STS equivalence regime – a way to recognise non-UK STS securitisations from countries of territories (jurisdictions) with STS frameworks that are equivalent to the UK's. Industry respondents to the call for evidence were supportive of HM Treasury creating such a regime to provide more choice for UK investors. This Bill introduces such a regime.

4.10 By allowing overseas securitisations from jurisdictions equivalent to the UK to be labelled as 'STS equivalent non-UK securitisations', this regime will provide UK investors with confidence that the securitisation meets standards equivalent to UK STS standards. This will provide UK investors with greater choice for investing in securitisations with the most efficient capital requirements.

**Policy objective**

4.11 The policy objective is to increase choice for UK investors who want to invest in STS securitisations. This should support the growth and liquidity of the STS securitisation market, both in the UK and internationally.

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[40] The entity which originates the loans being securitised or purchases a third party's loans to be securitised.

[41] A credit institution or investment firm, which is not an originator, and establishes and manages certain types of securitisations.

[42] A type of short-term securitisation, where the securities issued have an original maturity of one year or less.

[43] Securitisation Regulation: Call for Evidence. HM Treasury, December 2021.

**Description of options considered**

4.12 Option 0 (Do nothing) - Firms will not get preferential capital treatment from investing in any non-UK STS securitisations, even though those securitisations may be of an equivalent standard to UK-STS securitisations.

4.13 Option 1 (Preferred Option) - Introduce an STS equivalence regime. An STS equivalence regime will require an assessment of the STS framework in another jurisdiction by HM Treasury, as supported by the FCA and PRA, prior to recognising non-UK STS securitisations. This will balance the appropriate protections for the UK market with granting UK investors more choice in STS securitisations. That is because it ensures only STS securitisations from jurisdictions with an STS framework which HM Treasury is satisfied is equivalent can receive the same preferential capital treatment as UK STS securitisations.

4.14 Option 2 (Non-preferred) - Amend the requirement for STS securitisations to be issued by entities established in the UK. This would mean UK firms can get preferential capital treatment for investing in STS securitisations issued by originators and sponsors from any jurisdiction. This option has been dismissed on financial stability grounds. Without an assessment of other jurisdictions' STS frameworks, this would raise the risk that that less capital is held by UK investors for their investments in STS securitisations which fulfil less stringent requirements than UK STS securitisations, which is not appropriate.

**Outline of preferred policy**

4.15 This Bill will create a framework for HM Treasury to designate jurisdictions as equivalent in relation to specified descriptions of securitisations. These specified securitisations issued by originators and sponsors in the designated jurisdiction will be recognised as 'STS equivalent non-UK securitisations.' HM Treasury may make these designations using secondary legislation.

4.16 To make a designation, HM Treasury will consider whether the other jurisdiction's law and practice, as it relates to specified securitisations, has equivalent effect (taken as a whole) to applicable UK law. In doing so, HM Treasury will consider the advice of the FCA in consultation with the PRA. The FCA and PRA are the key competent authorities responsible for supervision of compliance with the Securitisation Regulation in the UK.

4.17 If a jurisdiction is designated, then the provisions in the Bill will mean that specified securitisations from that jurisdiction will be treated the same way as UK STS securitisations.

4.18 At the point of secondary legislation, and in line with the government's approach to better regulation under the Better Regulation Framework, HM Treasury will make efforts to further consult on and understand the potential further impacts of this measure, including through appropriate stakeholder engagement. More detailed qualitative and quantitative cost-benefit analyses are expected to be covered in the IAs accompanying the relevant secondary legislation enabled by the Bill. HM

Treasury will also engage with the RPC, prior to the submission of IAs produced to accompany future secondary legislation where appropriate.

**Methodology**

4.19 The costs and benefits for these provisions have been estimated against a scenario where there is no regime recognising STS equivalent non-UK securitisations.

4.20 The measure will allow HM Treasury to designate jurisdictions following an assessment. Any impact on firms would only arise in the event that HM Treasury does designate one or more jurisdictions. This decision would be given effect through secondary legislation. HM Treasury will conduct Impact Assessments (which may be de minimis) for all secondary legislation making such designations.

4.21 Given this, there is not an EANDCB for this measure.

4.22 The costs and benefits associated with an exercise of the power to designate another jurisdiction will depend on which jurisdictions are designated, and on the value of STS equivalent non-UK securitisations from those jurisdictions held by UK firms.

4.23 However, this analysis considers the potential impacts that the measure could facilitate, by allowing the possibility of STS equivalent non-UK securitisations to be recognised in the UK.

4.24 The main monetary benefit of this measure and subsequent secondary legislation is expected to be on the capital requirements for CRR firms and Solvency II firms. To calculate this, the estimated impact on capital requirements has been based on the current requirements under the CRR and Solvency II. Both CRR firms and Solvency II firms' actual requirements will vary based on a number of factors, including the credit rating and/or modelled risk of the securitisation, as well as whether they are on standardised approaches or use internal models for their capital requirements. However, it is not practical to estimate the credit ratings and/or modelled risk of future securitisations.

4.25 For the purpose of this analysis, the capital requirements for CRR firms have been based on the risk-weight floors[44] for securitisations which apply to all CRR firms. For Solvency II firms, the analysis uses the Standard Formula spread-risk capital requirements. Solvency II firms on Internal Models will calculate the capital requirement based on their own internal modelling, however the Standard Formula requirements can be used as an indication of what these may be.

4.26 The analysis uses internal PRA estimates for the exposures of CRR firms and some Solvency II firms to EU STS securitisations during the temporary recognition period when they are recognised as STS in the UK. This is an example of the potential exposures of UK firms to STS equivalent non-UK securitisations from a jurisdiction that is designated. If a jurisdiction other than the EU is designated, then the benefits are likely to be different based on a number of factors. For example, the amount of

[44] Risk-weights are the amount of capital that must be held against an exposure, presented as a percentage of the total exposure. Risk-weight floors set a lower limit below which the risk-weights for an exposure cannot fall. This means that the actual risk-weights for an exposure may be higher than the risk-weight floor.

STS equivalent non-UK securitisations being issued in that jurisdiction and UK investor appetite for them will impact how much capital benefit is gained.

Population within scope of this proposal

4.27 Following a designation of another jurisdiction, this measure could affect any firm which invests in, or seeks to invest in, STS equivalent non-UK securitisations. In particular, the following firms will be most affected as this measure may change the amount of capital they are required to hold against these investments: CRR firms (banks, building societies, and PRA-designated investment firms) and firms subject to Solvency II (insurance firms). There are around 371 CRR firms and 280 Solvency II firms in the UK.[45]

**Policy costs**

Transitional costs for firms

4.28 There are no one-off costs to firms as a result of this measure. Firms are not expected to need to devote any material resource to familiarising themselves with either the measure in the Bill or any subsequent secondary legislation designating a jurisdiction, as that is expected to be short and simple: identifying the jurisdiction and specifying the description of securitisations that will be considered STS equivalent non-UK securitisations.

Ongoing costs to firms

4.29 There are not expected to be any ongoing costs to firms. Although the FCA and PRA are funded by a levy on regulated financial firms, the overall cost is not expected to be high enough to make a difference to the amount registered firms are charged.

Transitional costs to the public sector

4.30 Under the new regime, the FCA and PRA will not be responsible for designating or supervising STS equivalent non-UK securitisations from a designated jurisdiction, as these responsibilities will fall to that jurisdiction's competent authorities. Because of this, the FCA is also not expected to keep or update a list of STS equivalent non-UK securitisations, as it does for UK STS securitisations.

4.31 Therefore, there are no costs expected for the designation, supervision, or registration of additional STS securitisations, or for setting up new application forms or IT systems.

Ongoing costs to the public sector

4.32 As a result of this measure, the FCA – in consultation with the PRA – will produce a comprehensive report on the law and practice in a jurisdiction that is being assessed, as it relates to specified securitisations, in order to inform HM Treasury's assessment. This will lead to an administrative cost. These costs are considered ongoing as, once the framework is in place, HM Treasury can decide to undertake an

45 See the PRA's Business Plan 2021/22.

assessment of another jurisdiction at any point. There are also ongoing costs of monitoring other jurisdictions after a designation is made, but these will arise as a result of the secondary legislation that makes the designation.

*Assessment costs for a jurisdiction*

4.33 The FCA/PRA will need to assess other jurisdictions' law and practice to decide whether they have equivalent effect to the UK's. As the FCA have not had to do this in the past for securitisations, this analysis uses estimates of administrative costs for a comparable regime - the Overseas Funds Regime (OFR), which was introduced in the Financial Services Act 2021 and allows overseas collective investment schemes to be marketed to investors in the UK market on appropriate terms. In the FS Act 2021 Impact Assessment for the OFR provisions, the FCA estimated that a single assessment takes 6-12 months and requires 3-4 FTE employees.

4.34 The FCA's and PRA's assessments for this regime are likely to be simpler than the OFR assessments. Assessments of other jurisdictions in the OFR must examine the general law and practice for retail collective investment schemes and for money market funds (MMFs), including considering whether investor protection is at least equivalent (for retail collective investment schemes). This is a broader consideration than that required under the STS securitisation regime, which is whether the law and practice of another jurisdiction, as it relates to specified securitisations, is equivalent to applicable law in the UK (i.e. the UK Securitisation Regulation and the Securitisation Regulations 2018 (S.I. 2018/2188), as they both relate to STS securitisations).

4.35 Therefore, to account for the narrower and simpler reports expected to be delivered by the FCA with input from the PRA, the resource expected can be reduced from the OFR baseline, with an estimate of each assessment taking 3 to 6 months and involving 2 to 3 full-time employees (1 manager and 1 to 2 associates) at both the FCA and PRA (so 4 to 6 employees total at the FCA and PRA).

4.36 To calculate the cost to the FCA and PRA of assessing a jurisdiction, the number of employees needed is multiplied by their salary and amount of time it takes to conduct the assessment. This is shown in Formula 4.A.

<u>Formula 4.A</u>

*Total cost of assessment per regulator = (annual wage cost of 1 manager + (number of associates x total wage cost of associates)) x percentage of the year spent on the assessment*

4.37 This formula is used to calculate how much the FCA[46] will spend on the assessment of each jurisdiction:

c. FCA low estimate = (£80,000+£53,000) x 0.25 = £33,250

[46] At the FCA, the estimated average salary for a manager is £80,000 and for an associate £53,000. This is based on the mid-range proposed salary for FCA employees in London (p. 22-23) for a regulatory manager and two associates. See FCA internal consultation: Proposed changes to your grading, pay structure and benefits.

d. FCA high estimate = (£80,000+(2 x £53,000)) x 0.5 = £93,000

e. FCA mid-point estimate = £63,125

4.38 The same formula can be used for the PRA,[47] leading to the following costings:

f. PRA low estimate = £31,875

g. PRA high estimate = £90,000

h. PRA mid-point estimate = £60,938

4.39 These can be added together, to estimate the total assessment costs for the FCA and PRA combined. The mid-point assessment cost for the FCA and PRA combined is £124,063.

*Monitoring costs for each jurisdiction*

4.40 Where a designation of a jurisdiction is granted in secondary legislation, the FCA and PRA will need to monitor the relevant law and practice of each designated jurisdiction for any potential changes. This is estimated to take 25% of an associate's time annually.

4.41 Therefore, annual monitoring costs per jurisdiction = £13,250 (for FCA) + £13,125 (for PRA) = £26,375.

**Policy benefits**

4.42 This Bill will set up a regime which will allow HM Treasury to designate jurisdictions in relation to specified securitisations using secondary legislation. The benefits described here will arise as a result of these designations being made in secondary legislation.

Transitional benefits to firms

4.43 There are no transitional benefits expected to firms from this measure. All benefits from preferential capital treatment last while firms hold exposures to STS securitisations. This can be interpreted as a one-off benefit at the time of investment, however this is classified as on-going because the savings on capital are made for as long as the exposures are held.

Ongoing benefits to firms

*Greater choice of high-quality securitisations and better liquidity for all UK investors*

4.44 This regime will allow for the pool of recognised STS securitisations available to UK investors to be enlarged.

[47] At the PRA, the estimated average salary for a manager is £75,000 and an associate is £52,500. This is based on the mid-range salaries for a scale E manager and two scale F associates, see PRA salary ranges from Dec 2021.

4.45 Although CRR firms and Solvency II firms will benefit in terms of capital requirements, as set out below, there is also wider signalling benefit in that the STS equivalent non-UK securitisations will be available to other types of UK institutional investors, including FCA investment firms, AIFMs, USCITS, and occupational pension schemes. Growth of the STS securitisation market – including UK STS and STS equivalent non-UK securitisations – should promote transparency and standardisation of securitisations being invested in by UK firms, as well as supporting them in diversifying their portfolios, which is beneficial to all types of institutional investors.

4.46 Additionally, if the STS securitisation market grows, this can be expected to help improve liquidity for these securitisations. This should be beneficial both for investors and issuers of STS equivalent non-UK securitisations and UK STS securitisations, thus benefitting the market as a whole.

*Regulatory capital savings for CRR firms and Solvency II firms*

4.47 If other jurisdictions are designated by HM Treasury, this will enable CRR firms and Solvency II firms to invest in STS equivalent non-UK securitisations from that jurisdiction at a lower cost in regulatory capital.

4.48 The estimated total capital benefit (i.e. how much money firms can save on fulfilling their regulatory capital requirements) that firms will get from the measure depends primarily on two things:

a. The difference in capital requirements for STS versus non-STS securitisations

b. How much UK firms invest in STS equivalent non-UK securitisations from designated jurisdiction(s)CRR and Solvency II firms are required to hold less capital against eligible STS securitisations than against non-STS securitisations. For CRR firms, the risk-weight floor (i.e. the minimum risk-weight) for the senior tranche of eligible STS securitisations is 10%, as opposed to 15% for non-STS securitisations.

4.49 According to internal PRA estimates from June 2021, CRR firms have exposures to approximately £4.4 billion of EU STS securitisations with an average risk weight of 12%. This is higher than the 10% floor for senior positions in STS securitisations because some firms hold non-senior positions with higher risk weights and some other positions may not satisfy additional prudential criteria for the 10% risk weight floor. This is compared against the 15% risk-weight floor for non-STS securitisations, however the actual average risk-weights for these same exposures if they were considered non-STS may also be higher, and so the relative capital requirement benefit may be greater.

4.50 For Solvency II firms on Standard Formulas, the spread-risk capital requirement for senior positions with a 10-year outstanding duration is 12% for eligible A-rated, and 22.5% for eligible BBB-rated STS securitisations, as opposed to 100% for non-STS securitisations.

4.51 According to internal PRA estimates from Q3 2021, Solvency II firms on Internal Models held an estimated combined value of £56 million in exposures to public EU

STS securitisations (this doesn't account for exposures to private STS, or for Standard Formula firms). No estimated average spread-risk capital requirement for these exposures is available, therefore the analysis uses an average capital requirement of 17.25% (an average of the 12% (A-rated) and 22.5% (BBB-rated) spread risk capital requirement).

4.52 These requirements and estimated exposures to EU STS securitisations can be used to estimate the benefit for CRR and Solvency II firms during the transitional arrangement which recognises them in the UK. This can then be used as an example of the benefits to firms from one jurisdiction being designated – see tables 4.A and 4.B below.

Table 4.A: Estimated capital benefit for CRR firms

| | **If recognised as STS** | **If not recognised as STS** |
|---|---|---|
| **Average risk weights** | 12% | 15% |
| **Calculation (Estimated exposures to eligible EU STS x average risk weight x 8% capital requirement)** | £4.4 billion x 12% x 8% | £4.4 billion x 15% x 8% |
| **Capital requirement** | £42,240,000 | £52,800,000 |

4.53 Therefore, CRR firms who have invested in EU STS would be required to hold an estimated total amount of £10,560,000 more in capital (20% more) against these exposures if the EU STS hadn't been recognised as STS in the UK.

Table 4.B: Estimated capital benefit for certain Solvency II firms[48]

| | **If recognised as STS** | **If not recognised as STS** |
|---|---|---|
| **Average spread risk capital requirement on the Standard Formula (for senior positions only)** | 17.25% | 100% |
| **Calculation (Estimated exposures to eligible EU STS x capital requirement)** | £56 million x 17.25% | £56 million x 100% |
| **Capital requirement** | £9,660,000 | £56,000,000 |

4.54 Therefore, some Solvency II firms on Internal Models would be required to hold an estimated total amount of £46,340,000 more in capital (83% more) against these exposures if the EU STS hadn't been recognised in the UK.

[48] These are the estimated capital savings for Solvency II firms on Internal Models who hold public EU STS securitisations. It does not account for exposures of firms on Internal Models to private EU STS or for any EU STS exposures of firms on Standard Formulas.

4.55 These calculations suggest that the temporary recognition of EU STS in the UK has saved CRR firms and Solvency II firms at least £56,900,000 in capital requirements in total.

**Assumptions, limitations and considerations**

4.56 The costs and benefits presented here are calculated on the basis of one jurisdiction being designated, using the EU as an example. Costs and benefits will be added for every additional jurisdiction that is granted equivalence. HM Treasury will conduct Impact Assessments (which may be de minimis) for all secondary legislation designating jurisdictions.

4.57 There are at least five jurisdictions which currently have implemented, or are considering implementing, the BCBS-IOSCO international standards for STC securitisations, and therefore may be more likely to be considered for designation (given the fact that the UK's STS framework is in line with the STC standards).

4.58 While the assessment and monitoring costs for the FCA and PRA can be multiplied per every jurisdiction designated, it is difficult to estimate the capital requirements benefits for other jurisdictions, including because different jurisdictions are likely to have different sizes of securitisation markets. There are also other determinants of demand for STS securitisations beyond the country of origin and whether there is capital benefit for holding a position in that securitisation. Therefore, firms' investment choices cannot be predicted with certainty.

4.59 Finally, as the number of securitisations available to UK investors at preferential capital treatment increases, this could mean higher demand (and more investment) in STS securitisations in general as the market is expected to be more liquid. On the other hand, it could mean lower demand for STS securitisations from any individual jurisdiction as there is more supply overall.

**Small and MicroBusiness Assessment (SaMBA)**

Number and distribution of businesses in scope of the regulation

4.60 Firms which are subject to the Capital Requirements Regulation and relevant PRA rules (referred to as 'CRR firms') and insurance firms which are subject to prudential requirements under the Solvency II regime (referred to as 'Solvency II firms'), who invest in STS securitisations, are impacted by this legislation. Based on data provided by the regulators, there are around 371 CRR firms and 280 Solvency II firms in the UK.[49]

4.61 There is no definitive data on the market share or proportion of how many of the 371 CRR firms are small and microbusinesses. Estimates may be made using certain assumptions based on:

a. Turnover: One of the metrics used within the definitions of 'small companies' is a turnover of £10.2 million or less. According to the PRA, 25 of the 371 CRR

[49] See the PRA's Business Plan 2022/23

firms (about 6.7% of total CRR firms) had annual net operating income below £10.2 million.

b. Firm Size: Separately, of the 371 CRR firms, 87 have reported employment figures to the FCA. 11 of these 87 firms have fewer than 50 employees, and therefore, can be considered as SMBs based on RPC guidance. If this is used as a proxy and the proportion is scaled up to account for the 371 CRR firms total, it can be extrapolated that 47 firms may be small or microbusinesses (about 12.7% of total CRR firms).

4.62 This suggests that anywhere between 6.6% to 12.7% of CRR firms impacted by the measure may be SMBs.

4.63 Similarly, there is limited data available for Solvency II firms, which the PRA does not hold any employment figures for.

4.64 However, based on data available to the PRA, if a gross written premium (GWP)[50] threshold of £10.2 million is used as a proxy indicator for whether a firm is a small or microbusinesses, then there are at least 84 insurance firms which have GWP below this threshold and could be considered as small and microbusinesses (30% of 280 Solvency II firms total). However, there is no available GWP data on 20 firms. It is possible that some of these may have GWP below the £10.2 million threshold.

Do the impacts fall disproportionately on small and microbusinesses?

4.65 There are no direct costs to firms, including small and microbusinesses, as a result of this measure. As with larger firms, small and micro businesses are not expected to need to devote any material resource to familiarising themselves with either the measure in the Bill or any subsequent secondary legislation designating a jurisdiction, as only the fact that a jurisdiction has been designated is material.

4.66 The measure has indirect benefits to CRR and Solvency II firms in the form of preferential capital treatment for investing in STS-equivalent non-UK securitisations, where the relevant jurisdiction has been designated by the UK, as a result of this measure. These impacts do not disproportionately benefit small and microbusinesses, as they will be eligible for the same preferential capital treatment as their larger counterparts.

4.67 Ultimately, the costs and benefits to SMBs will depend on any future decisions on designating one or more jurisdictions. Since such decisions will be given effect through secondary legislation, HM Treasury will consider impacts in more detail as part of the Impact Assessments (which may be de minimis) at that stage.

Could small and microbusinesses be exempted while achieving the policy objectives?

4.68 The potential impacts on CRR and Solvency II firms – including any small and microbusinesses – are only beneficial. These benefits should include potential capital benefits, greater choice, and better liquidity for STS securitisations they invest in.

50 The total value of premium (direct and assumed) written by an insurer before deductions for reinsurance and ceding commissions.

Therefore, it would not be appropriate to exclude them from this measure and curtail the potential benefits they would be eligible for.

Could the impact on small and microbusinesses be mitigated while achieving the policy objectives?

4.69 It is not possible or appropriate mitigate the impact on SMBs because there are no disproportionate costs to SMBs, and the expected impact is positive, as all relevant SMBs who are CRR or Solvency II firms will be eligible to receive preferential capital treatment for investing in STS-equivalent non-UK securitisations.

Wider impacts on small and microbusinesses

4.70 The measure could have wider indirect benefits for some SMBs in the UK. The UK recognising overseas STS securitisations could lead to greater competition for investment between STS securitisations issued by UK firms and STS securitisations issued by firms in recognised equivalent jurisdictions. If any UK small and microbusinesses (including those outside of the financial services sector) issue STS securitisations, they could be affected by this increased competition, which could make raising financing in this way more difficult and/or more costly. However, increased competition could affect any UK firm, whether or not they are a small or microbusiness. In addition, given the relatively small size of the STS securitisation market, it is not certain that increased competition would be particularly consequential for UK firms which issue STS securitisations, SMBs or otherwise.

4.71 However, the measure may also lead to overseas recognition of UK STS securitisations, which would provide businesses issuing securities in the UK– including any small and microbusinesses who issue them – with greater demand and greater liquidity for their STS securitisations.

**Monitoring and Evaluation**

4.72 In line with the government's approach to existing equivalence regimes, no formal monitoring and evaluation is expected for this measure.

# A sector at the forefront of technology and innovation

## Financial Market Infrastructure: Regulatory Sandboxes

**Problem under consideration**

5.1 As mentioned previously, in financial markets, there are various processes that need to be performed to complete each transaction. These processes are performed by several different types of entity collectively referred to as 'financial market infrastructures' (FMIs). Such processes encompass a range of activities underpinning the functioning of financial markets, including trading services (i.e. facilitating parties to enter into financial transactions) provided by trading venues, and post-trade services such as clearing and settlement (giving effect to trades by transferring securities and payment between parties) provided by central counterparties and securities settlement systems.

5.2 Some FMIs are considered systemically important, meaning that the failure of such an FMI could lead to financial instability, with subsequent negative impacts on the real economy due to the disruption this would cause to the proper functioning of the financial markets, which many economic activities rely on. It is therefore important that there is a robust regulatory framework to manage any risks associated with the use of new technology and adoption of new practices by FMIs.

5.3 It is however also important that FMIs can innovate and adopt new technologies or practices. These could allow firms to reduce their operating costs and perform in new and better ways, and markets to operate more effectively. Effective competition and innovation enable agile companies to meet customer needs and challenge incumbents by providing better services. However, it is not yet clear what legislative changes will most effectively support FMIs in their safe use of new technology or practices.

5.4 A particular example of this is Distributed Ledger Technology (DLT), which enables the sharing and updating of information records in a distributed and decentralised way. Since some of the key functions that FMIs perform relate to the accurate maintenance of, and access to, records of financial transactions, DLT could potentially make FMI services more efficient, more resilient and more transparent.

5.5 In 2021, HM Treasury conducted a Call for Evidence to examine the application of DLT to FMIs.[51] A key issue identified in responses to the Call for Evidence was that the UK legislative framework has not been built to support the use of DLT in FMIs, and that a reconsideration of the legislative framework would be needed to enable the use of DLT and to realise the potential benefits while ensuring regulatory objectives were met.

[51] UK regulatory approach to cryptoassets and stablecoins: consultation and call for evidence - GOV.UK (www.gov.uk)

5.6 Additionally in feedback to the Wholesale Markets Review (WMR) consultation[52] – which was published in March 2022 – respondents agreed that the current regulatory regime can represent a barrier to SME financing on public markets. The FMI Sandbox could be tailored to test new types of venues to improve companies' access to primary and secondary markets.

**Rationale for intervention**

5.7 As the functioning of FMIs, and their use by those operating in financial markets, is highly regulated, the potential benefits of DLT or new forms of trading venue will only be able to be explored if the regulation governing FMIs is amended or modified to allow it. Government intervention, in the form of legislation, is therefore required.

5.8 The UK's withdrawal from the EU also presents opportunities to undertake regulation in a more flexible way, as the UK is no longer required to adopt EU rules on financial services. Inflexible legislation has been highlighted by industry as making it harder for firms to innovate.

5.9 The Kalifa Review[53], an independent report on the UK Fintech sector commissioned by the Chancellor and published in February 2021, noted the potential opportunities that could be delivered using technology in financial services, and set out clearly the need to encourage innovation in this area. Amongst its recommendations were the need to ensure that regulation creates an enabling environment to encourage growth and competition, with the use of regulatory sandboxes cited as a way of achieving this goal.

5.10 Additionally, in feedback to the WMR, respondents agreed that the current regulatory regime can represent a barrier to SME financing on public markets. Some respondents also put forward a proposal for a new venue that would operate trading windows instead of offering trading on a continuous basis. The use of FMI Sandboxes could enable government, working with regulators, to address these issues.

**Description of options Considered**

5.11 Option 0 (Do Nothing) - FMIs underpin financial market activity and should be encouraged to improve the services they offer clients through research and innovation. Under the current model, firms are already innovating in some areas. However, without action, firms will continue to face barriers to innovating, particularly when adopting technology such as DLT, in the form of ambiguous or incompatible legislation, and therefore it would not be possible to realise any potential benefits from innovation, e.g. the adoption of DLT. Furthermore, HM Treasury and the regulators will continue to lack the evidence base for making changes to legislation that will facilitate innovation in future.

52 UK Wholesale Markets Review: a consultation

53 https://www.gov.uk/government/publications/the-kalifa-review-of-uk-fintech

5.12 Option 1 (Preferred Option) - legislating to allow HM Treasury to modify and disapply FMI legislation in 'Sandboxes' in the context of a specific FMI activity or new form of trading venue.

5.13 This will enable the testing of new technology or practices in financial markets in a controlled manner and with close oversight.

**Outline of preferred policy**

5.14 The Bill will give HM Treasury the ability to modify and disapply FMI legislation in 'Sandboxes' in the context of a specific FMI activity or new form of trading venue.

5.15 The term 'sandbox' has been applied in different ways, both in and outside of financial services. Broadly, it is an expression used to refer to a safe place within which to experiment and learn. In 2016, the FCA launched the world's first financial services sandbox, which allows businesses to test new services, technologies and products in financial markets, but in a controlled manner and with close oversight by the FCA. Within the sandbox the FCA can use its existing powers to waive or modify its own rulebook where a rule is considered to be unduly burdensome. There are also other tools available to firms in the FCA Sandbox, such as the use of informal steers on the potential implications of a particular business model. This concept has been supported around the world, and in January 2022 there were 32 sandboxes in operation globally.54 However, the existing FCA sandbox does not enable changes to be made to legislation itself.

5.16 This Bill provides HM Treasury with the powers to set up one or more sandboxes to disapply or modify elements of the existing legislation for FMIs, to enable firms to test new technologies and practices when providing FMI services. The measure defines what would constitute a participant in an FMI Sandbox, and includes existing recognised CSD and recognised trading venues. Participants would need to meet the required regulatory standards in a sandbox. HM Treasury will have the ability to add to the legislation in scope using a statutory instrument. Each individual sandbox would allow the government to test proposed changes to legislation in a safe and controlled environment before reporting to Parliament and making any permanent changes to legislation.

5.17 The measure will give HM Treasury the ability to disapply or modify legislation to allow firms to innovate in the sandboxes. The FMI legislation in scope of this power includes elements of retained EU law and domestic legislation implementing EU law, in particular the UK Central Securities Depositories Regulation, the Markets in Financial Instruments Regulation and the Market Abuse Regulation; legislation implementing UK law, such as the Settlement Finality Regulations; and existing UK law, in particular the Uncertificated Securities Regulations and the Companies Act. The full list of legislation in scope is listed on the face of the Bill. HM Treasury will have the ability to add to the legislation in scope of the FMI Sandbox using a statutory instrument, which is necessary in order to ensure that any sandbox is effective.

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[54] https://dfsobservatory.com/content/regulatory-sandboxes

5.18 If further sandboxes are considered to be required, each future sandbox will be created by a statutory instrument, and a full impact assessment will be prepared. Each statutory instrument will set out:

a. The FMI legislation to be modified or disapplied.

b. The activities that FMIs are permitted to undertake in the individual sandbox. For example, HM Treasury may choose to include securities issuance, settlement and maintenance in scope of a sandbox, activities currently performed by central securities depositories (CSDs). Temporary modifications to legislation could enable participants of the sandbox to perform these activities using DLT. HM Treasury could also allow certain activities that are currently performed by separate FMIs to be combined into one entity within a sandbox. For instance, a Sandbox could potentially allow a trading venue to perform securities issuance, settlement and maintenance (in addition to trading), while under current legislation these activities may only be performed by a CSD.

c. Requirements and restrictions for participants in a sandbox. This could include the types of securities that participants will be allowed to issue/trade/settle, and in what quantities.

d. The role of the regulators in running a sandbox and how enforcement powers will be used.

e. The duration that a sandbox will operate. HM Treasury will also have the power to terminate a sandbox sooner at its discretion.

f. The exit strategy that is required by participants in the sandbox and how the FMI intends to transition and continue its activities outside a sandbox on a permanent basis or manage the wind-down of its sandbox activities.

5.19 Aside from where provisions have been modified or disapplied to accommodate innovation, participants in a sandbox would be required to comply with all the relevant legislation that would apply to the activity they are undertaking. Participants in a sandbox would be expected to maintain existing high standards, and regulatory outcomes (in particular consumer protection and financial stability) would continue to be safeguarded.

5.20 HM Treasury will be able to create a transitional regime which would allow firms to continue to rely on the sandbox provisions during its wind-down, or whilst waiting for permanent changes to FMI legislation to be made.

5.21 HM Treasury will be required to report to Parliament on each Sandbox, providing a description of the arrangements in that Sandbox, an evaluation of how those arrangements have performed, and what changes HM Treasury intends to make permanently to legislation. The regulators will be required to work with HM Treasury in preparing this report, particularly in helping to inform a judgment on which legislative provisions should either be adopted in their modified form, disapplied on a permanent basis, or whether additional or novel modifications to legislation should be made to enable the effective adoption of DLT by FMIs. Any permanent legislative

changes would be made by a further statutory instrument, for which another Impact Assessment would be prepared.

**Methodology**

5.22 The precise design and operational details of a sandbox will be set out in secondary legislation that is enabled by the Bill. This secondary legislation will determine the details of the legislation that will be disapplied or modified, which firms may be able to join a sandbox, and what activities they can undertake. HM Treasury will provide a further impact assessment in each instance where it makes such secondary legislation.

5.23 However, to inform an assessment of the possible costs and benefits to firms as a result of the creation of a sandbox for the purpose of enabling FMIs to test new innovation in the market, the government has considered the costs and benefits of the existing FCA Sandbox and other similar financial services sandboxes around the world. It is important to note however that the below costs and benefits are illustrative and any costs and benefits to firms will be contingent on the exact nature of a sandbox (e.g. its design and the supervisory model to be applied) and what legislation is modified.

5.24 Participation in an FMI Sandbox will be entirely optional (subject to regulator approval), and firms considering participation will need to estimate any costs of participation and decide whether there is a strong enough business case to do so. If firms do not choose to participate in a sandbox then they will continue to operate under the existing legislation that currently applies to them.

5.25 At the point of secondary legislation, and in line with the government's approach to better regulation under the Better Regulation Framework, HM Treasury will make efforts to further consult on and understand the potential further impacts of this measure, including through appropriate stakeholder engagement. More detailed qualitative and quantitative cost-benefit analyses are expected to be covered in the IAs accompanying the relevant secondary legislation enabled by the Bill. HM Treasury will also engage with the RPC, prior to the submission of IAs produced to accompany future secondary legislation where appropriate.

**Policy Costs**

Transitional costs for firms

*Familiarisation costs*

5.26 If firms are eligible for and choose to participate in a sandbox they will incur familiarisation costs. These would be associated, where relevant, with adapting to provisions in legislation they do not currently apply to them (for example retained CSDR for firms authorised under MiFID, where they want to perform activities in the scope of CSDR), and to understanding the changes in secondary legislation and how these relate to the firms. Any firms that do not currently have existing relevant authorisations will have to achieve authorisation and compliance, and so adaptation costs may be higher. The nature of these costs will be assessed in the course of preparing legislating for the appropriate Statutory Instruments. Given the voluntary

nature of the sandbox, this would be something a firm would consider when choosing whether or not to apply to enter a sandbox.

*Costs of applying to join a sandbox*

5.27 Firms wishing to participate in a sandbox will have to apply, which will require resources and thorough preparation to ensure a viable application. For example, to participate in the current FCA sandbox:

a. Applicants must provide detail on their business operations on areas such as governance, risk, security and competition.

b. Applicants must summarise their innovative proposal and give extensive detail on how the service they have selected will engage with the temporarily modified and disapplied legislation.

c. Applicants must outline how they meet the FCA's eligibility criteria.

d. Potential participants must prepare and submit detailed plans of the tests to be undertaken in the sandbox and develop a framework for measuring performance and success.

5.28 HM Treasury intends to adopt a similar approach, albeit with the involvement of both the Bank of England (Bank) and the FCA, although the precise costs of applying to each sandbox will depend on the detailed design of the sandbox as specified by HM Treasury in secondary legislation, as well as any further requirements imposed by regulators.

5.29 Applicants to a sandbox will have to provide an appropriate level of justification for any modifications to legislation they seek to have applied within the sandbox. To understand the full scope of regulatory changes required in order to operationalise their business models, firms may have to procure legal advice. Currently it costs firms on average around £350 per hour for advice from law firms specialising in this field of law.[55]

*Cost of building new systems to join the sandbox*

5.30 Once firms have applied to join and been accepted to the FMI Sandbox, they will need to ensure that they are able to participate. This would require investment to build new and innovative systems, and provide the resourcing needed to operate them (covered below).

<u>Ongoing costs to firms</u>

[55] This figure is based on discussions with industry

*Cost of running the platform*

5.31 There may be ongoing costs to firms that choose to participate in the FMI Sandbox and are successful in their application to do so. These costs may include firms hiring staff to run the Sandbox process, operating costs and legal fees.

*Cost of winding down sandbox operations if they were not successful*

5.32 A firm may deem participation in a sandbox unsuccessful if they decide that the platform being tested is unviable economically, or does not deliver greater benefits than existing systems, and decide to exit a sandbox. Alternatively, the regulators may decide that a particular participant is unable to meet a regulatory requirement (for example if a participating firm fails to provide adequate cybersecurity protections or does not safeguard the integrity of security issuances) In either of these cases the participating firm would need to bear the costs of winding down their sandbox operations.

*Cost of transitioning to operate outside a sandbox if successful*

5.33 Following successful completion of their tests in the sandbox, FMIs will need to transition out of a sandbox. It is important that firms have adequate safeguards in place to ensure that they are able to operate safely outside the sandbox.

5.34 If firms want to continue operating in the way they have been in the FMI Sandbox once a sandbox concludes, the government may need to implement permanent changes to general law outside the Sandbox to facilitate this. Transitional measures may also need to be put in place by the government to ensure firms can continue to operate in the interim while the government makes permanent changes to legislation so as to avoid any legislative cliff-edge. Firms may need to apply to the FCA or Bank to ensure they have all the appropriate authorisations in place to operate outside of the Sandbox.

Transitional costs to the public sector

*Cost to the Bank/FCA of setting up a sandbox*

5.35 Regulators will need to dedicate resource to setting up each sandbox, for example policy and legal resource to design how a sandbox will operate, any further requirements to be levied on participants, and determining the application criteria. The cost to the regulators will depend on how each sandbox is specified by HM Treasury in legislation, for example how specific the application criteria will be.

Ongoing costs to the public sector

*Cost to the Bank/FCA of supervising sandboxes*

5.36 The Bank and FCA will incur ongoing costs for the duration of a sandbox, due to having to dedicate supervisory capacity to overseeing firms in each sandbox. Regulators may have to develop IT systems and novel risk assessment techniques to appropriately monitor and supervise FMIs using new forms of system within the sandbox. The nature of these costs will be determined by the secondary legislation specifying each Sandbox.

**Policy Benefits**

Transitional benefits for firms

There are no transitional benefits expected to firms from this measure. All benefits from a sandbox will last for the duration of the operation of a sandbox.

Ongoing benefits for firms

*Greater innovation in FMIs and trading venues*

5.37 Through a sandbox firms will have the opportunity to apply new technologies, such as DLT, and practices to the provision of FMI services, potentially realising substantial benefits. This could include, for FMI services, increased efficiency (FMI processes, such as settlement of securities, could be performed faster while cutting out unnecessary administration), increased resilience (for instance settlement of transactions could be made more reliable and less prone to failure) and more transparency (participants in financial markets could have greater visibility over transactions and market activity) and greater access to UK capital markets for UK firms and businesses.

5.38 Firms will only apply to operate within a sandbox if they see a potential benefit to doing so, due to opportunity to develop a new line of business, or a different way of doing business that is beneficial when compared to their current practice.

*Regulatory framework adapted to innovation*

5.39 Firms in a sandbox will be able operate under legislation and regulation that expressly and unambiguously allows new innovations in the provision of FMI services, particularly when applying new forms of technology, while still meeting the same regulatory outcomes as at present. This means new business models can be adopted, and the potential of these business models fully realised, due to existing barriers in legislation being removed.

Ongoing benefits for the public sector

*Knowledge and expertise gained*

5.40 Throughout the lifetime of a sandbox, HM Treasury, the Bank and the FCA will be able to gather valuable information that they can use to supervise new risks that may have come about due to new innovation. They will have been able to observe the development and implementation of these changes. The enhanced knowledge gained by regulators during the development of the sandbox will allow updates to regulatory and supervisory policies.

5.41 It is expected that any legislative modifications or disapplications deemed successful in a sandbox will be adopted permanently. The sandbox approach means that before any permanent changes are made, regulators will have already been given opportunities to understand and shape how the new technologies work and will therefore be able to regulate them more effectively. This will in turn benefit the firms subject to this regulation.

**Assumptions, limitations, and considerations**

5.42 As each sandbox will engage different activities and use different technology and each participant will have reached a different stage of technological development, it is not possible to estimate how much it will cost to set up each individual sandbox. HM Treasury, working with the Bank and FCA will decide the exact regulatory requirements that will be applied, modified and disapplied to firms in a sandbox.

5.43 Given each sandbox is designed to test modifications to legislation, and the modifications being tested will depend on the specification of each sandbox (which will be set out via Statutory Instrument), it is not possible at this stage to make any quantitative estimates as to either the costs or benefits to business that may arise under a given design. The government will prepare a full impact assessment to accompany any secondary legislation that is introduced to create each sandbox.

**Small and MicroBusiness Assessment (SaMBA)**

Number and distribution of businesses in scope of the regulation

5.44 The businesses in scope of an individual FMI Sandbox will depend on how each Sandbox is specified in secondary legislation following consultation with industry, and in particular will depend on decisions about what sort of firm is in scope. A further impact assessment will be provided when each statutory instrument is laid before Parliament.

5.45 At a minimum, the government anticipates including central securities depositories (CSDs) and multilateral trading facilities in the Sandbox, though it may be that other forms of firm could be allowed to participate, provided they are able to demonstrate that their proposed business model meets the relevant regulatory requirements. According to information provided by the regulators, there are 36 MTFs currently authorised in the UK and one CSD. While HM Treasury does not have employee numbers for the individual authorised CSD, its annual turnover of €197 trillion would suggest that it is not classified as a SMB.[56] HM Treasury is not able to confirm the classification of all the individual MTFs, as in many cases the information is unavailable (in some cases due to being part of a larger firm, with no segregated data provided for the MTF). However, it is possible that some multilateral trading facilities that could participate may be classified as SMBs, particularly when the data is taken at company level (rather than wider group level). There may, of course, be further firms that participate in a future sandbox which could qualify as an SMB and who cannot be included in this analysis.

Do the impacts fall disproportionately on small and microbusinesses?

5.46 As mentioned previously, participation in an FMI Sandbox will be entirely optional (subject to regulator approval). Firms, including any considered to be small and microbusinesses, will need to estimate any costs of participation and decide whether there is a strong enough business case to do so. If firms do not choose to participate

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56 https://www.euroclear.com/content/dam/euroclear/investor-relations/annual-reports/2021/Documents/Annual%20Review%202021.pdf

in a sandbox then they will continue to operate under the existing legislation that currently applies to them.

5.47 HM Treasury therefore does not anticipate an impact that falls disproportionately on small and microbusinesses. The overall impact should be a benefit to markets, given that FMI legislation could evolve to accommodate more effective technologies and practices.

5.48 As set out above, FMIs themselves are generally not small businesses but larger entities, which provide the infrastructure services that enable financial markets to operate. The Sandbox could enable both existing incumbent FMIs and new entrants intending to provide FMI services to adopt new technologies and practices that are not currently accommodated in FMI legislation.

5.49 The government will set out the scope of each sandbox when it lays the necessary secondary legislation to establish a sandbox. The government will therefore consider the impact on SMBs as part of the secondary legislative process. This could include considering what levels of investment might be required for firms to participate in a sandbox, what the cost of legal compliance may be, and whether these costs are likely to prove prohibitive for SMBs, if they wish to participate. A further impact assessment will be provided setting out the impact on SMBs as part of the secondary process, and government will consult with industry when preparing secondary legislation.

Could small and microbusinesses be exempted while achieving the policy objectives?

5.50 Given the Sandbox is intended to enable the legislation underpinning financial market infrastructures to evolve, and for firms to adopt new technology and practices when providing FMI services, this measure should not exempt small and microbusinesses as they should be able to benefit in the same way larger firms should if they choose to participate and determine that it would be beneficial to do so.

Could the impact on small and microbusinesses be mitigated while achieving the policy objectives?

5.51 The government will set out the scope of each sandbox when it lays the necessary secondary legislation to establish a sandbox. The government will therefore consider the impact on SMBs as part of the secondary legislative process. This could include considering what levels of investment might be required for firms to participate in a sandbox, what the cost of legal compliance may be, and whether these costs are prohibitive for SMBs. As part of this policy development process, the government will consider the appropriateness of any mitigating measures for SMBs who wish to participate in the sandbox. A further impact assessment will be provided setting out the impact on SMBs as part of the secondary process, and government will consult with industry when preparing secondary legislation.

Wider impacts on small and microbusinesses.

5.52 It is not possible to determine at this stage whether any SMBs will apply directly for the FMI Sandbox.

5.53 The Sandbox could benefit smaller firms in an indirect way, as it may be that new technologies and practices in FMIs could facilitate cheaper or better access to financial markets for smaller firms (such as enabling them to more easily issue debt in capital markets).

## Digital Settlement Assets

**Problem under consideration**

6.1 Cryptoassets are a digital representation of value or contractual rights that can be transferred, stored or traded electronically, and which may (though does not necessarily) utilise cryptography or distributed ledger technology. However, no internationally agreed definition, taxonomy or classification exists.

6.2 As of October 2022, the global market capital of cryptoassets was estimated to be $0.99trn.[57] Large swings in the value of individual cryptoassets and the total market capitalisation is common. For example, in early May the total value of cryptoassets fell by around $0.6trn (around 33%) following the depegging of TerraUSD from its dollar peg.

6.3 The size of the UK cryptoassets market is still small but rapidly growing. The FCA's consumer research from 2021 found that 2.3m consumers held crypto in the UK, which makes up 4.4% of UK adults. This is an increase from 3.9% in 2020, with ownership likely to have grown since. Stablecoins, an evolution of cryptoassets which aim to maintain a stable value by referencing a stable asset (typically fiat currency), are taking an increasing share of the market.

6.4 Stablecoins are a form of cryptoasset which aim to maintain a stable value relative to other assets. Design features vary, including how the stablecoin is backed or stabilised, for example by linking the value of a stablecoin to another financial asset with low volatility or by using an algorithm to increase or decrease the supply as needed to maintain a stable price.

6.5 Stablecoins which reference their value to fiat currencies could be seen as more similar to traditional financial instruments compared to other cryptoassets such as Bitcoin. Depending on the specific way that they are designed, stablecoins may already be subject to UK financial services regulation, though many fall out of scope.

6.6 The total value of the global stablecoin market has risen from USD $5 billion in 2020 to USD $147.2billion in October 2022. However, this is still only a small percentage of the total cryptoasset market. As of October 2022, the two largest stablecoins are Tether and USD Coin, both of which are pegged to US-dollar denominated assets.

6.7 Stablecoins are currently primarily used to enable the trading, lending and borrowing of cryptoassets, often on exchanges (platforms which facilitate trading of cryptoassets). However, the responses to the government's recent consultation[58] highlighted that some firms would like to use stablecoins as a widespread means of payment. This could make payments cheaper and faster to process compared to traditional payment rails (such as card schemes) and could stand to reduce the cost

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57 Figures from CoinMarketCap. Available at: https://coinmarketcap.com/charts/

58 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1066166/O-S_Stablecoins_consultation_response.pdf

of cross-border transactions (such as remittances). Payment service providers are also considering using stablecoins as means of payment for these reasons.

6.8 There is currently no comprehensive regime in the UK for regulating cryptoassets including stablecoins. The principal area where cryptoassets have been subject to regulation to date has been Anti-Money Laundering legislation. Many stablecoins fall outside the regulatory perimeter which means that they are not subject to the same consumer protections or safeguards found in other payment systems[59] or forms of e-money. This is inconsistent with the principle of financial services regulation that activities that pose the same risks should be subject to the same regulatory treatment.

**Rationale for intervention**

6.9 Given their characteristics, the government believes that stablecoins have the potential to be used as a means of payment, similarly to electronic money (e-money), however they often, due to their characteristics, fall out of scope of the payments regime

6.10 E-money[60] is, broadly, monetary value as represented by a claim on the issuer (an entity which issues e-money) which is: stored electronically, including magnetically; issued on receipt of funds; and used for the purposes of making payment transactions. The Bill will provide HM Treasury with powers to bring stablecoins used as means of payment into the regulatory perimeter via secondary legislation.

6.11 It is important to regulate payment systems as their failure could lead to systemic problems throughout the financial sector, in addition to consumer protection, market integrity and competition. The ability of individuals and businesses to make and receive payments safely and smoothly with confidence is critical to financial stability. Disruption or outage within the stablecoin chain could lead to consumers being unable to access their money and make payments. This might be particularly problematic if the chain is systemic.

6.12 As seen during the market volatility experienced in cryptoasset markets in May 2022, use of stablecoins also has the potential to cause significant consumer harms. These include, in the first instance, the risk that consumers could lose money through volatility of the value of the stablecoin or system failure. Risks are likely to be increased where consumer protections are limited – for example, due to an absence, uncertainty or failure of a claim for redemption. There is also a potential cyber risk whereby tokens could disappear and become unable to be used to make payments.

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[59] A payment system is a set of institutions, such as banks, insurance companies, and stock exchanges, that permit the exchange of funds.

[60] As per Regulation 2 of the EMR, "electronic money" means electronically (including magnetically) stored monetary value as represented by a claim on the electronic money issuer which—

(a) is issued on receipt of funds for the purpose of making payment transactions;

(b) is accepted by a person other than the electronic money issuer; and

(c) is not excluded by regulation 3;

Consumers may also not understand the product or service they are being offered and consumer data could be lost or misused.

6.13 Consumer harm could also derive from models being too complex, or excessive prices, fees and charges. In addition, there are risks of fraud, financial crime, cyberattacks or maladministration, with potential for consumer harm if services are vulnerable to operational and security risks leading to inaccessibility or inefficiencies.

6.14 The government intends to create the conditions for stablecoin issuers and service providers to operate and grow in the UK, in line with the government's firm commitment to place the UK's financial services sector at the forefront of cryptoasset technology and innovation. For consumers, bringing stablecoins into the regulatory framework means that they will be able to use stablecoin services with confidence.

6.15 However, these developments also present new challenges and risks – including risks to consumers and to the financial system. The regime will aim to balance the government's ambition to foster competition and innovation in the sector against the emerging risks in this space.

**Description of Options Considered**

6.16 Option 0 (Do nothing) - This approach would be inconsistent with the government's approach to similar risks arising in the context of financial services and would continue the current situation whereby stablecoins are not regulated in the same way as e-money and payments systems, despite posing similar risks. Normally risks of this nature, such as those to financial stability, market integrity and consumer harm, are subject to rigorous regulation enforced by independent regulators with a statutory mandate.

6.17 Option 1 (Preferred Option) - regulating stablecoins. This approach would bring stablecoins into the regulatory perimeter, which is consistent with the government's approach to regulating financial services more broadly. This approach would be targeted to stablecoins used as payment.

6.18 Option 2 (Non-preferred) - industry self-regulation. HM Treasury could work with industry bodies to develop a code of conduct enforced by industry self-regulation. This option may permit greater flexibility to accommodate rapid changes in the fast-moving cryptoasset market as the regime would be devised by those closest to the products and services involved. However, this approach would not be sufficiently robust as it does not match the stringent regulation of existing payment systems (e.g. e-money) which stablecoins share characteristics with.

**Outline of preferred policy**

6.19 Through this legislation, the government seeks to take a power to bring digital settlement assets, which are forms of digital assets used for payments, into the regulatory perimeter. The government intends to use the powers in the Bill to initially provide for the regulation of stablecoins backed by fiat currency (such as Pound Sterling), which are a form of digital settlement assets. The Bill extends the Banking Act 2009 (BA 09) and the Financial Services (Banking Reform) Act 2013

(FSBRA) to include payment systems and service providers which use digital settlement assets. These amendments are aimed at financial stability and competition regulation. The Bill also provides the Treasury with powers to make regulations in relation to payments and payment systems that use digital settlement assets, as well as a power to make insolvency arrangements in respect of such systems. Secondary legislation will create an FCA authorisation and supervision regime, and set out the mechanism for managing co-responsibility for regulation for systemic digital settlement asset providers between the Bank of England (Bank) and the FCA. Broadly, this will seek to ensure that fiat-backed stablecoins, where used for payments, are subject to the same requirements and protections as other similar payment methods.

6.20 Given the cross-border nature of cryptoassets, the UK government and regulators are committed to working with other jurisdictions and through the international standard-setting bodies to support harmonisation of treatment as far as is feasible. In doing so, the proposed approach should allow for changes to reflect international discussions, including on equivalence where relevant.

6.21 The government will also seek to ensure that the regulatory approach to cryptoassets is consistent with the outcomes of the Payments Landscape Review and FRF Review, which have considered how the regulatory framework for financial services and payments need to adapt to be fit for the future.

6.22 Specifically, this policy approach will:

a. Establish an FCA authorisation and supervision regime through secondary legislation drawing broadly on existing e-money and payments regulation to mitigate conduct, prudential and market integrity risks for issuers of, and payment service providers using, stablecoins. This would include adding a new regulated activity to ensure regulation captures wallet providers (providers which offer storage solutions for cryptoassets) given their expected role in providing services to consumers.

b. Enable HM Treasury to recognise systemic payment systems and service providers using digital settlement assets for regulation by the Bank subject to meeting relevant thresholds. This will enable the Bank to regulate and supervise systemically important stablecoin payment systems and related service providers to mitigate financial stability risk.

c. Enable the PSR to regulate stablecoin payment systems (through FSBRA), following HM Treasury's publication of a designation order, to address issues relating to competition innovation, user interests and access.

d. Apply the Financial Markets Infrastructure Special Administration Regime (FMI SAR) which is a bespoke resolution regime for payment and settlement systems in amended form to stablecoin firms that have been recognised by HM Treasury (under b) so as to ensure appropriate tools are in place to mitigate the risks to financial stability associated with a systemic stablecoin firm's failure.

e. Create a mechanism to amend or disapply existing FCA rules in areas relating to financial stability to avoid relevant stablecoin firms being subject to competing requirements.

f. Expanding definitions to ensure that current regulatory framework applies to stablecoins.

6.23 As noted above, the government will use secondary legislation to create an FCA authorisation and supervision regime for stablecoins. This will be based on existing FCA payments regulation, such as the Electronic Money Regulations 2011 (EMR 2011) and Payment Systems Regulations 2017 (PSR 2017), and as such, existing conduct and safeguarding requirements would likely apply. The government's intention is to capture stablecoins that reference fiat currencies, including a single currency stablecoin or stablecoin based on a basket of currencies (otherwise known as multi-currency stablecoins.

6.24 Broaden the definition of payment system in Parts 5 of the BA09 and FSBRA.

6.25 The BA09 provides the Bank with power and responsibility for regulation of systemically important payment systems, and service providers to those payment systems. HM Treasury has the power to recognise payment systems and service providers that are considered to be systemically important (i.e. those payment systems where any disruption of the system's operation would be likely to have serious consequences for those who use the services provided by the system).

6.26 FSBRA gives the PSR the responsibility for the regulation of regulated payment systems and participants within those systems, from a competition and innovation perspective. HM Treasury has the power to designate payment systems as a regulated payment system for the purposes of Part 5 of FSBRA, for payment systems where any deficiencies in the design of the system or any disruption of the system's operation would be likely to have serious consequences for those who use the services provided by the system (i.e. payment systems that are systemically important).

6.27 The Bill will broaden the definition of a payment system in the BA09 to include systems using 'digital settlement assets', so that HM Treasury can recognise systemically important payment systems that use stablecoins. This will allow the Bank to regulate the financial stability and resilience aspects of systemic stablecoin systems in the same way that it currently regulates other payment systems that have been designated by HM Treasury.

6.28 Similarly, the Bill will broaden the definition of funds in FSBRA to include systems using 'digital settlement assets'. This will allow the PSR to regulate the competition, innovation and user interest aspects of designated stablecoin payment systems, in the same way that it currently does for other payments systems.

6.29 The Bill will amend the PSR's powers to include a defined set of service providers to which regulation will apply. This will include wallets, but also other entities such as exchanges. Extensions in this way will apply only to payments systems making use of 'digital settlement assets', and will be framed in such a way as to provide a degree of flexibility to account for the future unpredictable evolution of stablecoin-based

systems. Individual firms will still need to be designated in order for regulatory powers to be used, but the PSR's concurrent competition powers would continue to apply to any payment system active in the UK including those making use of digital settlement assets.

6.30 When HM Treasury brings stablecoins and related activities into regulation, businesses will need to comply with the regulations that their activities come under. They will need to ensure that they follow the correct prudential and organisation requirements, as well as any reporting requirements and consumer protections.

Systemic Digital Settlement Asset service providers

6.31 The Bill will extend Bank supervision to systemic 'digital settlement asset' service providers (e.g. wallets). The Bank currently only regulates systemic payment systems and their associated service providers, however Treasury is consulting on changes to the Bank's remit to supervise other forms of systemic risk within payment chains. Certain stablecoin wallets used to safeguard or exchange stablecoin keys could pose systemic risks if used at scale because of the potential wider impact of any disruption (e.g., of consumers' ability to withdraw funds).

FCA creation of regulatory requirements

6.32 As a result of extending the payments regulatory perimeter, the FCA will need to create a detailed set of regulatory requirements applicable to digital settlement assets. This will cover prudential and organisational requirements; reporting requirements; conduct of business requirements; custody/safeguarding requirements; and redress/consumer protections.

Special Administration Regimes

6.33 As stablecoins are a new innovation in financial services, there is currently ambiguity as to how the failure of a DSA payment system or service provider would be managed with the tools and regimes that are currently in place to manage the failure of different types of financial services firm. The Financial Markets Infrastructure Special Administration Regime (FMI SAR) is intended to manage the failure of FMI firms. There is also a Payment and E-money Special Administration Regime (PESAR") designed to manage the failure of payment and e-money firms. As a result of this legislation, either of these regimes could potentially be used to manage the failure of a DSA payment system or service provider which is being regulated by both the FCA and the Bank.

6.34 The Bill will therefore give the government the powers it needs to remove that ambiguity by amending the FMI SAR and PESAR legislation, and related legislation, to provide that, in the event of the failure of such a system or provider, the FMI SAR should be used, rather than the PESAR, and to ensure that the FMI SAR can effectively deal with such a failure.

6.35 The government is taking a power to make such amendments due to the need to consult on the detailed and technical changes needed to the FMI SAR, and the need to be able to ensure that the amendments reflect the nature of the DSA market, which is still at an early stage.

6.36 A consultation on the intended amendments to the FMI SAR closed in August 2022.

Co-responsibility for regulation

6.37 Under the proposed regime, it is anticipated that a small number of systemic firms will become subject to regulation by both the Bank and the FCA. This is an existing feature of the current regulatory framework for investment firms and banks. For such firms, the application of FCA rules may need to be amended or disapplied in areas relating to financial stability (such as prudential requirements) to avoid firms being subject to competing requirements.

6.38 The government intends to establish a mechanism for achieving this via secondary legislation. Any secondary legislation will be accompanied by an appropriate impact assessment.

**Methodology**

6.39 The impacts below are compared to a scenario where the regulation has not been introduced (the 'do nothing' approach); however, it is important to note that independent of the changes in policy there is likely to be technological innovation and increased use of stablecoins.

6.40 As explained above, it is not possible to accurately estimate the number of firms which will be affected by these legislative changes. For this reason, the general costs associated with the proposed regime is set out below.

6.41 Some of these costs below will also depend on detail set within regulator rules, which HM Treasury cannot prejudge in this analysis given that they will be subject to public consultation. The regulators rules will be subject to cost-benefit analysis in the usual way.

6.42 Further details will be set out in the secondary legislation that is enabled by the Bill. HM Treasury will provide a further impact assessment in each instance of a where it makes such secondary legislation. However, to inform an assessment of the Bill the government has set out the possible costs and benefits. It is important to note however that the below costs and benefits are illustrative and any costs and benefits to firms will be contingent on the exact nature of the secondary legislation.

6.43 At the point of secondary legislation, and in line with the government's approach to better regulation under the Better Regulation Framework, HM Treasury will make efforts to further consult on and understand the potential further impacts of this measure, including through appropriate stakeholder engagement. More detailed qualitative and quantitative cost-benefit analyses are expected to be covered in the IAs accompanying the relevant secondary legislation enabled by the Bill where required. HM Treasury will also engage with the RPC, prior to the submission of IAs produced to accompany future secondary legislation where appropriate.

**Policy Costs**

6.44 HM Treasury expects that firms will face costs as a result of the proposed regime. This will primarily be composed of FCA authorisation and associated costs with being

regulated under the e-money regime. However, for a very small number of systemic firms, there will be additional costs from being regulated by the Bank and the PSR.

6.45 It is challenging to estimate the number of firms which will be in scope of FCA authorisation, Bank and PSR regulation. This is primarily because it is difficult to collect data on firms which are currently not regulated and because stablecoins are a new and not very well-established product, which few firms currently offer.

Transitional costs to firms

*Familiarisation and legal costs*

6.46 As a result of bringing stablecoins and related activities into regulation, businesses will need to familiarise themselves with the new legislation, including to ensure that they follow the correct prudential and organisation requirements, reporting requirements and consumer protections. The exact impact on businesses will depend on subsequent secondary legislation laid by the government and rules introduced by the regulators.

6.47 Drawing on the FCA's 2020 consultation on High-risk investments: Marketing speculative illiquid securities (including speculative mini-bonds) to retail investors, HM Treasury assumes the following estimates of costs for familiarisation:

a. Compliance familiarisation costs: £63/hour for compliance staff costs per head including 30% overheads, with 5 compliance staff each reading 40 pages of FCA policy guidance at 300 words per page at 100 words per minute.

b. Legal familiarisation costs: £69/hour for legal staff costs[61] per head including 30% overheads, with two lawyers reading 20 pages of legal text at 300 words per page at 100 words per minute.

6.48 The total costs faced by firms will depend upon the length and detail of final legislation combined with the length of relevant regulator rules.

Ongoing costs to firms

*FCA Authorisation costs*

6.49 Under the proposed regime, a range of firms (such as stablecoin issuers) currently not required to be authorised by the FCA will be required to be authorised by the FCA.

6.50 For example, the FCA charges electronic money institutions (EMIs) an authorisation fee.[62] This fee currently breaks down as follows, depending on institution size:

a. Small electronic money institutions: £1,000

b. Authorised electronic money institutions: £5,000

[61] From engagement with the sector, w it has been estimated that lawyers in this sector will charge £69 per hour.

[62] https://www.handbook.fca.org.uk/handbook/FEES/3/Annex10.html

*FCA levy costs*

6.51 In addition to the authorisation fee, EMIs are required to an ongoing levy to the FCA, contributing to the costs of FCA regulation and supervision. These break down as follows:

a. In 2021/22, there was a flat annual levy of £1,198 for small electronic money institutions.[63]

b. In 2021/22, there was a flat annual levy of £1,726 for large electronic money institutions.

6.52 In addition to the flat fee, there is a variable rate annual levy calculated as follows:

a. The variable rate fee is £40.50 per £ millions of average outstanding electronic money over a threshold of £5.0m.

*PSR levy costs*

6.53 The majority of firms that will fall into the scope of proposed regulation will be subject only to FCA regulation and supervision, with costs set out as above.

6.54 However, firms meeting criteria set out in legislation – particularly relating to scale and competition considerations – will be subject to regulation and supervision by the PSR.

6.55 The PSR's Fees Policy Statement 2018[64] sets out which firms are required to pay fees and the methodology used to calculate these fees. Every year the PSR will assign the PSR's overall annual funding requirement, the PSR's projected spend for a particular year, to two blocks – the transaction volume block and transaction value block. Each fee payer pays PSR fees based on the relative size of their total transaction volumes and total transaction values across all PSR-regulated payment systems.

6.56 Each fee payer's PSR fees is calculated using the following methodology:

a. Part 1: as a function of a given firm's transaction volumes:
(£17,182,260 * 80%) * (sum of firm's relevant transaction volumes in all systems / 70,651,794,216)

b. Part 2: as a function of a given firm's transaction values:
(£17,182,260 * 20%) * (sum of firm's relevant transaction values in all systems / 177,497,699,556,033)

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63 Definition of small electronic money institution (from the EMR):
(i) The total business activities of the applicant immediately before the time of registration must not generate average outstanding electronic money that exceeds 5,000,000 euro.

(ii) The monthly average over the period of 12 months preceding the application of the total amount of relevant payment transactions must not exceed 3,000,000 euro.

64 PSR Regulatory Fees. Available at: https://www.psr.org.uk/publications/policy-statements/ps-18-12-psr-regulatory-fees/

64 The PSR's Annual Funding Requirement is updated each year. £17,182,260 represents the Annual Funding Requirement for 2021/22.

*Bank payment systems and service providers' levy*

6.57 Firms that meet the criteria set out in legislation –relating to scale and systemic significance – will be subject to regulation and supervision by the Bank.

6.58 The Bank's levy is a flat levy set annually based on a cost recovery model:

a. For most significant (Category 1) firms: £0.67 million per annum

b. For significant (Category 2) firms: £0.45 million per annum

*Ongoing costs of compliance*

6.59 In addition to costs of legal and regulator rule familiarisation, firms will face ongoing costs of compliance, spanning the following cost areas:

a. Adaptation or expansion of compliance function, to ensure ongoing firm compliance with FCA, PSR and Bank rules and requirements (as appropriate).

b. Development of new firm procedures in line with compliance requirements, such as safeguarding and segregation of client funds, disclosure requirements, enhanced customer service requirements. The exact nature of these will depend on the nature of the rules created by the regulators. It is not possible at this stage to know what they are.

c. Broader business change and adaptation costs including updating web / customer onboarding flows.

d. Compliance with any directions given by regulators, including of the PSR and Bank.

*Increased capital requirements*

6.60 HM Treasury anticipates that firms will have increased costs as a result of capital requirements imposed on firms in scope of regulation. Given that these requirements will be subject to rule setting by the regulators, the operating cost to firms as a result of the requirements will depend on detailed rules.

6.61 To use existing FCA rules as an example, an authorised EMI must maintain at all times own funds equal to or in excess of the following:

a. For authorised EMIs, either EUR350,000 or 2% of the average outstanding e-money issued by the EMI, – whichever is greater.

b. For small EMIs generating outstanding e-money of EUR500,000 or more, it must maintain at all times own funds equal to or in excess of 2% of average outstanding e-money.

**Policy Benefits**

Benefits to firms

*Increased uptake of stablecoins*

6.62 Regulation is likely to increase user trust and boost the opportunity for these firms to operate in the UK. Authorised firms can offer the same products and services as other payment service providers with consumer protections that is likely to increase demand for stablecoins. Ultimately, this could lead to increased number of consumers for the firms in the long-run and for these stablecoins to be more widely used as means of payment.

*Responsible innovation for UK firms*

6.63 Regulation is likely to create an environment in which ongoing innovation can be continued or accelerated in the context of greater user trust. Quantifying the level of benefit that is likely to flow from increased trust and subsequent further innovation is not possible due to the level of uncertainty.

*Reduced risk of financial instability caused by stablecoins*

6.64 As set out above, the ability of individuals and businesses to make and receive payments safely and smoothly with confidence is critical to financial stability. Therefore, any operational disruption or outage within the stablecoin chain could lead to consumers being unable to access their money and make payments. It is therefore important to regulate the operational aspects of the stablecoin chain in order to maintain financial stability if, for example, there is an unexpected outage.

6.65 Furthermore, uncertainty about, or large fluctuations in, the value of the asset could give rise to similar risks to financial stability associated with the operational or financial failure of traditional payments systems. Generally, assets that function as money-like instruments should offer equivalent protections to existing forms of privately-issued money i.e., commercial bank money. And as such, be subject to high levels of protection including around stability of value, robustness of legal claim, and ability to offer one-for-one exchange to fiat currency. This can include prudential or capital requirements, or general conduct requirements relating to the activities of the firm.

6.66 The new regulatory requirements for systemic stablecoin payments systems and service providers will ensure that the potential financial stability risks posed by stablecoins are reduced.

Benefits to consumers

*Increased payment choice and competition*

6.67 The introduction of regulated stablecoin based payment systems could provide consumers with additional choice for payment services. The introduction of new payment systems could lead to greater competition between existing UK payment systems, potentially leading to lower costs and improved services in the long run.

*Reduced cross-border transaction costs*

6.68 Slow and expensive cross border payments are a burden to low-income consumers. Each year $700 billion is sent between countries, however the average cost of doing

this was 6.38% in Q1 2021.[65] Increased use of stablecoins has the potential to reduce this cost and enable consumers to send money across borders in a cheaper and easier way.

*Reduced risk of consumers losing money*

6.69 Under the PSR 2017 and EMR 2011, authorised payment institutions, authorised e-money institutions and small e-money institutions have a responsibility to ensure appropriate organisational arrangements are in place to protect the safeguarded funds. These measures are a pre-requisite for being granted an authorisation. They protect consumers by ensuring that those funds are either placed in a separate account from the institution's working capital and other funds, or are covered by an appropriate insurance policy or comparable guarantee. Therefore, upon insolvency, claims of e-money holders or payment service users will be paid from the asset pool formed from these funds.

6.70 Bringing stablecoins into the payments regulatory perimeter will therefore ensure that consumer money is protected in the case of insolvency or operational issues. Firms regulated by the Bank would be subject to additional oversight, the detail of which would depend on the detailed rules and codes set out by the Bank in the wake of legislation. This regulation would in particular look to ensure the ongoing stability of firms and markets, to the benefit of end users. Quantifying the benefits that would arise from increased stability of firms and markets for end users is not possible at present.

**Assumptions, limitations and considerations**

6.71 Ultimately, the impact of rules made by the regulators when compared to retaining the current rules will depend on the decisions made by the regulators line with their objectives. The impact of secondary legislation passed as a result of this Bill can also not be determined at this stage.

6.72 As it is not known, and has not been possible to estimate, how many firms are likely to be within scope of the legislation, it is not possible to come up with an overall EANDCB. When the secondary legislation is introduced, HM Treasury will produce a full impact assessment.

**Small and MicroBusiness Assessment (SaMBA)**

Number and distribution of businesses in scope of the regulation

6.73 As of August 2022, there are no examples of companies issuing fiat-referenced stablecoins in the UK that would fall within the proposed regulations. In this regard, this legislation is intended to be market-making by establishing the regulatory framework for such stablecoin operators to operate and grow in the UK.

6.74 Furthermore, given the difficulties in estimating the number of firms in the cryptoasset sector in the UK (as set out in previous sections of this chapter), it

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65 https://remittanceprices.worldbank.org/sites/default/files/rpw_main_report_and_annex_q121_final.pdf

follows that it is also difficult to estimate the number of small and microbusinesses that are likely to be affected by this measure.

6.75 HM Treasury has explored secondary research relating to the size of cryptoasset firms globally in attempt to establish a proxy for the average size of such firms. It found that data on the size and composition of the cryptoasset market is limited given the new and rapidly evolving nature of the sector.

6.76 The Cambridge Centre for Alternative Finance's 3rd Global Cryptoasset Benchmarking Study[66] estimated that the median cryptoasset firm size in Europe was 12 full time equivalent employees, with larger firms tending to locate in the North American or Asia-Pacific region. This study however reflects data collected in 2019, which was before a significant bull run in cryptoasset markets in 2021 and subsequent bear market in 2022 and is not specific to cryptoasset payment firms. The findings of the report also suggest that employment growth in cryptoasset sector is relative to the performance of the cryptoasset market.

6.77 Given the similarities between the characteristics of stablecoins used for payment and traditional forms of e-money, the market configuration of the latter may provide a more accurate proxy estimate. Figures from the FCA suggest that there are 559 registered small payment institutions in the UK, 34 of which are small EMIs (6%).

Do the impacts fall disproportionately on small and microbusinesses?

6.78 Most of the costs identified above relate to the funds required to become recognised as an authorised institution by the regulators as an EMIs. As set out in the FCA's guidance[67], which was updated in January 2021, small e-money institutions (defined as those with business activities which generate an average of less than 3 million euros (~£2,531,000 GBP) of e-money per month over the 12-month period preceding application for registration) are subject to lower authorisation costs than regular e-money institutions. This equates to a £1,000 fee for small EMIs compared to £5,000 for standard e-money institutions. EMIs are also required to pay an annual levy to the FCA. This is a flat fee: small EMIs pay £1,198 compared to £1,726 for larger institutions. Costs relating to the PSR's fees are also related to the size of a firm transaction values, which means that smaller businesses will pay less overall than larger institutions.

Could small and microbusinesses be exempted while achieving the policy objectives?

6.79 HM Treasury considered exempting small and microbusinesses from this legislation, however it concluded that it was not appropriate to do so as the harms to consumers from unregulated stablecoins are the same regardless of firm size. Exempting small and microbusinesses from this legislation would therefore be inconsistent with the government's objective of ensuring "same risk, same

[66] Cambridge Centre for Alternative Finance's 3rd Global Cryptoasset Benchmarking Study. Available at: https://www.jbs.cam.ac.uk/faculty-research/centres/alternative-finance/publications/3rd-global-cryptoasset-benchmarking-study/

[67] https://www.handbook.fca.org.uk/handbook/PERG/3A/4.html

regulatory outcome” in regards to financial services activity, and potentially lead to consumer harm and market integrity impacts.

Could the impact on small and microbusinesses be mitigated while achieving the policy objectives?

6.80 As set out above, small EMIs are already subject to lower authorisation costs as part of mitigations under the existing e-money regulations, which partially mitigates the impact on affected small and microbusinesses. Further mitigation of impacts will be considered as part of HM Treasury’s approach to secondary legislation.

Wider impacts on small and microbusinesses

6.81 HM Treasury has not identified any wider impacts specific to small and microbusinesses beyond those relevant to all providers (as set out in the wider impacts section below). Small and microbusinesses could however stand to benefit from this legislation should they choose to accept fiat-backed stablecoins as a means of payment (in line with the benefits for firms identified above). This can help to improve the efficiency of processing payments, and reduce fees associated with processing payments, including foreign exchange fees associated with cross-border transactions.

# A competitive marketplace promoting the effective use of capital

## Wholesale Markets Review

**Problem under consideration**

6.1 Regulations of wholesale capital markets govern the buying, selling and organised trading of financial instruments (such as shares, bonds, units in collective investment schemes and derivatives) between professional investors and companies.

6.2 Wholesale markets are vital to the UK economy as they underpin its growth by providing funding for companies, governments and individuals.

6.3 Prior to EU exit, the UK's legislation governing wholesale capital markets was predominantly set at the EU level and a harmonised set of rules applied across the whole EU, including the UK. To prepare for the UK's departure, the European Union (Withdrawal) Act 2018 transferred directly effective EU financial services legislation into the UK statute book and ensured that UK legislation implementing EU requirements remained in effect. This process was known as "onshoring" and included the UK legislation implementing the second Market in Financial Instruments Directive (MiFID II) and the directly applicable Markets in Financial Instruments Regulation (MiFIR). These were amended to address deficiencies arising as a result of the UK's withdrawal from the EU and are referred to together as the MiFID II framework.

6.4 The UK government played a fundamental role in designing the MiFID II framework when the UK was a member of the EU. In many areas, the regime is working well and has achieved its objective of enhancing the effectiveness of markets following the financial crisis. However, following the UK's exit from the EU, the government is committed to ensure that the regime reflects the UK's position as one of the largest capital markets globally, as well as the UK's commitment to high regulatory standards.

6.5 The breadth and complexity of the MiFID II framework have inevitably led to duplication, onerous regulation and excessive administrative burdens for firms. The government intends to make the system work better for firms by making the framework fit for purpose.

**Rationale for intervention**

6.6 The MiFID II framework was, where necessary, onshored and amended to address deficiencies arising as a result of the UK's withdrawal from the EU and the end of the Implementation Period via the European Union (Withdrawal) Act 2018 (EUWA).

6.7 The MiFID II framework entered into force in January 2018, meaning it has been four years since the last major update to the wholesale markets regime. It is also clear that the regulations have not in all cases delivered the intended benefits. Some rules were introduced to harmonise the rulebook across the EU's 28 member states and are not calibrated correctly for UK markets. Others are incredibly prescriptive in nature and have resulted in unnecessary frictions and costs for industry.

6.8 For example, in 2018 the MiFID pre- and post-trade transparency regime was extended to cover a number of non-equity instruments including bonds, exchange traded commodities, exchange traded notes, structured finance products, emission allowances and derivatives. Equity and non-equity markets are very different in nature: the former tends to consist of standardised instruments that are executed on electronic order books, whereas the latter includes a high number of bespoke instruments that are executed through voice, request-for-quote or bilateral negotiations. Although the MiFID II transparency regime intended to accommodate the specific characteristics of equity and non-equity markets, it did not go far enough in accounting for the fundamental differences between and within these different categories of markets. This has resulted in ill-suited requirements for a large number of fixed income and derivatives instruments which are burdensome to comply with while not achieving any meaningful transparency.

**Description of Options Considered**

6.9 Option 0 (Do nothing) - Under this option, HM Treasury would not make any changes to the regulatory regime for wholesale markets (the MiFID II framework). Firms would continue to operate under the existing regime that has been largely inherited from the EU. The problems outlined above would continue to persist and the regime would be inflexible, duplicative and complex. For example:

a. Firms would continue to face restrictions about where and how trading can happen, which reduce choice and their ability to get the best price for investors.

b. The transparency regime for fixed income and derivative markets would remain ill-calibrated, placing unnecessary burdens on firms and negatively impacting market participants' knowledge of asset prices.

c. Firms and investors who are active in commodity markets would continue to face unnecessary restrictions that limit market activity.

d. The FCA would not have the powers it needs to protect UK markets in the event of an unexpected change in global markets or wider market disruption.

6.10 These problems would ultimately be addressed using the powers implementing the outcomes of the Future Regulatory Framework (FRF) Review, however making these changes here ensures they come into force sooner.

6.11 Option 1 (Preferred Option) - The preferred option is to make legislative changes to the MiFID II framework to ensure that the regime reflects the UK's position as one of the largest capital markets globally. To establish the preferred option the government conducted a review of wholesale markets regulation through the Wholesale Market Review (WMR) consultation. The proposals that were included WMR consultation, which closed on 24 September 2021, aim to deliver a rulebook that is fair, outcomes-based and supports competitiveness, whilst ensuring the UK maintains the highest regulatory standards. They covered, but were not limited to, changes that could be made to equity, fixed income, derivatives and commodities markets regimes, as well as to rules on market data. The government received 78 responses to the consultation, and on 1 March, published its full response. This

summarised the feedback received and outlined the government's plans to deliver the most important changes.

Policy objective

6.12 The WMR consultation explained that the government's intention was to consult on specific changes to its wholesale markets regime alongside broader changes to the regulatory framework through the FRF Review. This is in recognition of the fact that some parts of the regime merit swift improvement. This Bill will make the legislative amendments that are most urgently needed. Where legislative changes are needed but consultation respondents indicated that fast implementation is not paramount, the government intends to wait until the outcomes of the FRF Review have been implemented to take them forward.

6.13 The changes implementing the outcomes of the FRF Review seek to ensure that having left the EU, the UK maintains a coherent, agile and internationally respected approach to financial services regulation that is right for the UK. To ensure consistency, the changes to the wholesale markets regime that are set out in this Bill are in line with this approach, insofar as they increase regulatory agility by transferring responsibility for rulemaking for some parts of retained EU law to the regulators.

6.14 To ensure that the regulatory framework for wholesale capital markets is appropriately tailored to the needs of UK, the Bill makes a number of changes to the MiFID II framework to:

a. Maintain high regulatory standards to ensure that firms can operate in confidence and that the UK sets an international example.

b. Promote openness and competitiveness to allow domestic and international investors to access the most liquid markets so that they can achieve the best prices for their investments, and to enhance the UK's position as a global hub for wholesale markets.

c. Deliver fair and proportionate regulation, focused on outcomes rather than prescriptive rules so firms do not face unnecessary frictions and costs.

6.15 Support economic growth, innovation, and wealth creation across society by ensuring that the regulatory framework can facilitate investment in both the short and long-term.

Outline of preferred policy

6.16 The Bill amends the MiFID II framework in four different areas:

a. Amendments to the equity regime – Equity markets are markets in which the shares of a company are issued and traded – also known as the stock market.

b. Amendments to the systematic internalisers regime – systematic internalisers are investment firms that deal on their own account when executing client trades outside of a trading venue, on an organised, frequent, systematic and substantial basis. These firms use their own capital rather than that of clients

or counterparties and are therefore a counterparty of the trade and take on their own risk.

c. Amendments to the fixed income and derivatives regime – Fixed income, or debt securities markets, trade government bonds, corporate bonds and other instruments designed to deliver a fixed return (in contrast to equities). Derivatives markets trade derivatives – financial instruments whose value is based on the value of an underlying asset – for example, the expected future cost of a currency or an index.

d. Amendments to the commodity derivatives regime – Commodity derivatives are derivatives whose value is derived from the price of an underlying commodity (often physical commodities such as agricultural products).

6.17 The following section outlines the specific amendments to each of the regimes as described above.

Amendments to the equity regime

6.18 The Bill makes a series of changes to the equity markets regime to ensure that market participants can trade on the venue where they can achieve the best outcomes for their clients. It will permanently remove two restrictions in respect of the trading of shares: namely the Share Trading Obligation (STO) and the Double Volume Cap (DVC), and will delegate responsibility for setting waivers from the pre-trade transparency regime to the FCA, who - as the independent and expert regulator - are better placed to determine which instruments or transactions should benefit from an exemption from the regime.

*Remove the Share Trading Obligation*

6.19 The Share Trading Obligation (STO) requires investment firms to ensure that the trades they undertake in shares admitted to trading on a venue, take place on a regulated market (RM)68 or multilateral trading facility (MTF)[69], a systematic internaliser[70], or an overseas trading venue assessed as equivalent by HM Treasury. The STO mirrors the Derivatives Trading Obligation (DTO), which was implemented to fulfil a G20 commitment to bring more derivatives trading onto exchange or

68 A regulated market (RM) is a multilateral system operated or managed by a market operator, which brings together or facilitates the bringing together of multiple third-party buying and selling interests in financial instruments (in the system and in accordance with non-discretionary rules) in a way that results in a contract, in respect of the financial instruments admitted to trading under its rules or systems. A UK RM is one that is a Recognised Investment Exchange (but not an overseas investment exchange).

69 A multilateral trading facility (MTF) is multilateral system operated by an investment firm or a market operator that brings together multiple third party buying and selling interests in financial instruments (in the system and in accordance with non-discretionary rules) in a way that results in a contract. A UK MTF is one that is operated by a UK firm or market operator and complies with the relevant statutory and regulatory requirements.

70 A systematic internaliser (SI) is an investment firm which on an organised, frequent, systematic and substantial basis deals on its own account when executing client orders outside of a regulated market, UK MTF or UK OTF, without operating a multilateral system. A UK SI is one which has its head office in the UK or which operates through a branch in the UK.

electronic platforms. The DTO requires financial counterparties[71], and some non-financial counterparties[72] to trade certain classes of derivatives[73] on UK authorised trading venues, or overseas trading venues that HM Treasury has recognised as equivalent.

6.20 However, unlike the DTO, the STO is not based on international standards or best practices. When it was implemented, policy makers believed that it would bring more trading onto lit markets[74] and increase transparency. However, there is no evidence that either of these objectives have been met. In fact, market participants have indicated that the STO has decreased competition between trading venues globally. In some cases, it has also limited firms' ability to execute trades at the venues where they can get the best price for investors.

6.21 Removing the STO will allow firms to trade shares on any trading venue in the UK or overseas, and with any counterparty on an over the counter (OTC)[75] basis, as long as best execution is upheld. This change will ensure that investors can get the best price for their trade, without negatively impacting price formation or market efficiency.

*Delegate the pre-trade transparency waiver regime to the FCA*

6.22 The MIFID II framework includes a pre-trade transparency regime for equities and equity-like instruments. This requires trading venues to publish quotes for trades before a trade is executed, increasing transparency in the market. This was designed to increase trading on lit venues. A lit venue is a market where bids and offers (prices to buy or sell) are posted publicly prior to any trade execution. Conversely, trading in a so-called 'dark venue', also known as a dark pool, means that pre-trade information is not publicly visible.

6.23 Pre-trade transparency helps the efficient price discovery process, but in some instances, it can inadvertently impair liquidity. For example, market participants can use pre-trade information to increase their prices or create a shortage of shares, which can result in false indications of liquidity. This can have a negative impact on price formation. To mitigate against this, MiFID II set out four pre-trade transparency waivers for equity and equity-like instruments, which firms can use to avoid publishing quotes before a trade has been completed. These include:

a. The reference price waiver, for systems that determine prices by reference to a price generated by another system- typically the primary market.

71 A financial counterparty (FC) is a regulated financial services firm falling within one of the seven categories specified in Article 2(8) EMIR.

72 A non-financial counterparty (NFC) is an entity established in the UK that is not a financial counterparty or a CCP (see Article 2(9) EMIR).

73 The FCA declares certain classes of derivatives to be subject to the DTO under the procedure set out in Article 32 MiFIR. They are listed in a public register maintained by the FCA, which can be accessed here.

74 A lit venue is a market where bids and offers (prices to buy or sell) are posted publicly prior to any execution.

75 Over-the-counter (OTC) trading of financial instruments outside the systems and rules of a trading venue.

b. The negotiated waiver, for transactions that are negotiated bilaterally but are reported on venues;

c. The large-in-scale waiver, for orders considered large-in-scale against normal market size.

d. The order management facilities waiver, for orders held in an order management facility of a trading venue pending disclosure. It also introduced a mechanism to limit the amount of trading that happens under the reference price and negotiated price waivers: the Double Volume Cap (DVC).

6.24 The Bill will revoke the existing system of waivers from pre-trade transparency requirements and instead give the FCA new rule-making powers to determine under which circumstances waivers are available and any conditions that are to be attached to their use. This will allow the FCA, as the independent and expert market regulator, to make evidence-based decisions about the circumstances in which waivers should apply.

6.25 As part of this change, the Bill removes the DVC from the MiFID II framework. The DVC limits the amount of trading that can be done without pre-trade transparency to 4% of all trading in an instrument at a single venue, and 8% across all venues. Under the MiFID II regime, when the former limit is reached the FCA must suspend the use of the waiver by that trading venue in that instrument, and if the latter is reached the FCA must suspend the use of the waiver by all trading venues, for a period of 6 months.

6.26 Research on the impact of dark pools on the integrity and efficiency of markets suggests that the relationship between price formation, execution costs and dark trading is complex and variable. It also shows that banning dark pools can result in volume moving into hybrid, quasi-dark trading mechanisms. When this happens, it is unlikely that volumes will return to transparent public markets.

6.27 The FCA's Occasional Paper No 29; Aggregate market data quality implications on dark trading[76], published in 2017, estimates that the threshold at which dark trading may start to negatively affect market quality is approximately between 11% and 17% of total trading by pound value. However, the exact amount depends on the specific market quality metric used. Evidence also shows that the use of dark pools can reduce the transaction costs of large institutional orders.

6.28 The government is of the view that the DVC is not an appropriate tool to protect price formation in UK markets and therefore the Bill will remove it.

6.29 However, to ensure market integrity, the FCA will continue to monitor the level of dark trading in markets and will retain its ability to limit it if there is evidence that the volume of trading is undermining the efficiency of the price formation process. The Bill will replace the DVC with a power for the FCA to suspend the use of any waiver by direction, after consultation with HM Treasury. The FCA's exercise of this

[76] https://www.fca.org.uk/publications/occasional-papers/no-29-aggregate-market-quality-implications-dark-trading

new power would be based on a variety of sources and market quality metrics, including views and analysis from market participants and other stakeholders.

6.30 This will reduce operational costs as firms will no longer have to manage internal systems that track the percentage of dark trading of individual shares and will give firms more flexibility when deciding how to execute trades. Having access to trade on all trading venues will allow firms the opportunity to achieve the best outcomes for their clients and will increase stability and predictability in the trading of equity instruments.

6.31 This ties in with the government's commitment to competitive markets that are supported by high regulatory standards while giving market participants choice over how and where they trade. It also aligns the UK's approach with other 20 international financial centres, such as the US, who do not have a DVC and have seen dark trading levels plateau at around 10%.

Amendments to the systematic internaliser regime

6.32 The Bill makes a series of changes to the systematic internaliser regime to remove unnecessary costs and burdens for firms and to ensure that systematic internalisers can offer their clients the best execution of their orders.

*Amend the definition of a systematic internaliser*

6.33 A systematic internaliser is an investment firm that deals on its own account when executing clients' orders outside of a trading venue on a 'organised, frequent, systematic and substantial basis'. The regime for systematic internalisers was originally determined on a qualitative basis. Its objective was to ensure that OTC trading in the form of systematic internalisation of order flows by investment firms could contribute to price formation. Internalisation of orders occurs when a firm executes a trade for a client using inventory the firm already has as opposed to going outside of the firm to another firm or a trading venue. The regime ensured that these 'internalised' transactions were made transparent to the market. MiFID II moved away from the qualitative definition and introduced quantitative thresholds, which are calibrated at different levels for each asset class, to determine if an investment firm must comply with obligations on systematic internalisers for a given asset or asset class. To determine whether they exceed the thresholds, investment firms are required to perform calculations for each financial instrument they deal in on a quarterly basis covering the previous 6-month period. These are costly for firms to complete and require a substantial amount of administrative work. To avoid these, a number of firms choose to simply opt-in to the regime.

6.34 The Bill amends the definition of a systematic internaliser in legislation to remove the requirement for firms to carry out these complex calculations. It gives the FCA a new power to specify how the language of a new qualitative definition of systematic internalisers should be interpreted. This power will be adaptable enough to give the FCA the necessary flexibility to tailor the scope of the regime to respond to changing market conditions.

6.35 These changes will simplify the regime and assist in delegating the setting of firm facing requirements to the expert regulator. They will also reduce costs and burdens for firms.

*Allow systemic internalisers to execute trades at midpoint*

6.36 'Tick sizes' set minimum increments ('ticks') by which prices for equities can change; in other words, they represent the smallest permitted price fluctuation for any particular equity. The tick size regime restricts so-called 'midpoint' trading. Midpoint trading is where a buyer and seller of a security are matched at a price that is half-way between (i.e. at the midpoint of) their respective offers to buy and sell. In other words, the tick size regime constrains trades happening where the price agreed is set at a fraction of the minimum increment (i.e. at a fraction of the tick size).

6.37 The MiFID II tick size regime sets these minimum increments for equity and equity-like instruments and therefore limits the ability of trading venues and systematic internalisers to cross at the midpoint, except for when they are trading orders that are large in scale.[77] A harmonised tick size regime was introduced under MiFID II for trading venues and was extended to systematic internalisers in 2020 in an attempt to create a fair balance between these entities and trading venues.

6.38 Prior to the introduction of the tick size regime under MiFID II, venues competed against each other with smaller and smaller price spreads to the detriment of the price formation process. The government supports the application of the tick regime across trading venues and systematic internalisers and believes it has mitigated the problem it sought to solve. However, the restrictions on midpoint trading for systematic internalisers have led to suboptimal outcomes for clients in some instances and, recognising the inherent differences between venues and systematic internalisers, the government does not believe the restrictions on midpoint crossing below large in scale are necessary.

6.39 The Bill removes restrictions on midpoint crossing for systematic internalisers. This will allow for price improvement and can provide investors with a better execution outcome. Midpoint crossing can lead to savings, as forcing a trade away from the midpoint essentially forces one side of the transaction to take up the spread between the buy and the sell price. This means that one counterparty must end up with a price that is worse from its perspective.

Amendments to the fixed income and derivatives regime

6.40 The Bill makes changes to the fixed income and derivatives regime to ensure that the scope of the transparency regime is appropriately calibrated. It also makes changes to the DTO in order to resolve ambiguity surrounding its scope, protect UK competitiveness and ensure that market stability and integrity can be upheld in the event of disruption.

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[77] Orders that are large in scale (LIS) benefit from pre-trade transparency waivers. The thresholds for these waivers are calculated and published by the FCA

*Amend the scope of the pre- and post-trade transparency regime for fixed income and derivatives instruments*

6.41 MiFID II established a pre- and post-trade transparency regime for fixed income and derivatives markets. The pre-trade transparency regime requires current bid and offer prices that are broadcasted through a venue's systems to be disclosed to the public. However, a complex system of waivers – which are supported by transparency calculations – offers exemptions from pre-trade transparency requirements if, for example: there is no liquid market for the instrument in question; an order is large in scale; the order is held in an order management facility pending disclosure; or if the order is a relevant package order.

6.42 The post-trade transparency regime requires certain details of transactions in fixed income and derivatives instruments to be made public in real time (within five minutes of execution), though not where post-trade deferrals apply.

6.43 The transparency regime for fixed income and derivatives markets is modelled on the transparency regime for equity markets that existed pre-2018. Although it was amended to accommodate for the specific characteristics of non-equity markets, it does not go far enough in accounting for the fundamental differences between and within the different categories of markets.

6.44 For example, the type of financial instruments that are in scope of pre- and post-trade transparency is determined, according to MiFIR, on the basis of whether the financial instrument (or class of instruments) is admitted to trading or traded on a trading venue (ToTV). The concept of ToTV is not a defined term under MiFID II, which has created ambiguity in relation to the boundaries of the transparency regime for OTC derivatives and resulted in a number of liquid instruments not falling in scope of the regime and negatively impacting price formation.

6.45 Additionally, the calculations that are used to determine which instruments can benefit from transparency exemptions, and that were originally designed for equity markets (where instruments are standardised and traded frequently), do not work effectively for fixed income markets. This is because trading tends to happen on an infrequent basis. Analysis conducted by the FCA, which compares the liquidity status of a random group of bonds as determined by the calculations against their "true" liquidity status, shows that between 52% and 69% of the corporate bonds that were included and which were determined as liquid under the MiFID II calculations, were in fact illiquid.

6.46 The complex assortment and length of deferrals has compromised the regime's transparency objectives. The Bill therefore repeals mechanisms and concepts that determine the scope of the transparency regime in legislation and delegates responsibility for determining the scope and functioning of pre- and post-trade transparency regime for fixed income and derivatives instruments to the FCA. The government believes that the expert regulator is better placed to create a more tailored regime that supports open and competitive markets, and that seek to achieve greater transparency in a more cost-effective way.

*Amend the scope of the DTO*

6.47 The Derivatives Trading Obligation (DTO) requires financial counterparties[78], and some non-financial counterparties[79] to trade certain classes of derivatives[80] on UK authorised trading venues, or overseas trading venues that HM Treasury has recognised as equivalent.

6.48 The Bill makes three amendments to the scope of the DTO in legislation:

a. Firstly, it amends which counterparties have to comply with the DTO in order to realign it with the scope of counterparties which are subject to the clearing obligation (CO) in the European Market Infrastructure Regulation (EMIR). The scope of the CO and DTO were intended to align; however, in 2019 the EMIR REFIT reforms amended the scope of the CO to exclude small financial counterparties. Because the scope of the DTO was not updated simultaneously, this has created an unintentional misalignment.

b. Secondly, it gives the FCA a new rule-making power to specify which post-trade risk-reduction services are exempt from the DTO. Currently only the termination or replacement of component derivatives in portfolio compression are exempt. Giving the FCA the power to exempt more categories of trades if needed will enable technical trades - that reduce the non-market risks of positions that market participants have entered into - to take place in an efficient manner.

c. To accompany this change, the Bill will also give the Bank a similar rule-making power to specify the post-trade risk-reduction services that are to benefit from an exemption to the clearing obligation. This will ensure that exemptions from the DTO and CO continue to be aligned. This is important in allowing the risk reduction service to achieve its intended effect. Expanding the exemption for trades stemming from post-trade risk reduction services will therefore encourage the use of such services by increasing their effectiveness.

d. Thirdly, it gives the FCA a new power to modify or suspend the DTO, including in respect of its scope, under certain conditions. This will help to protect UK markets in the event of an unexpected change in global markets or wider market disruption and help to prevent liquidity fragmentation.

Amendments to the commodity derivatives regime

*Delegating the position limits regime to the FCA*

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[78] A financial counterparty (FC) is a regulated financial services entity falling within one of the seven categories specified in Article 2(8) EMIR.

[79] A non-financial counterparty (NFC) is an entity established in the UK that is not a financial counterparty or a CCP (see Article 2(9) EMIR).

[80] The FCA declares certain classes of derivatives to be subject to the DTO under the procedure set out in Article 32 MiFIR. They are listed in a public register maintained by the FCA, which can be accessed here.

6.49 The MIFID II position limits regime imposes limits on the maximum size of a net position that a person can hold in a commodity derivative that is traded on a trading venue, or in an economically equivalent OTC contract.

6.50 Position limits were introduced in MiFID II with the objectives of preventing market abuse and ensuring orderly trading and settlement of commodity derivatives. Under the MiFID II framework, the FCA is required to establish and enforce position limits for all venue traded commodity derivative contracts. In practice, this means that they are obliged to set and monitor position limits on around 800 contracts in the UK. Additionally, UK trading venues are required to establish and operate their own position management controls (for example, to monitor positions and require a person to terminate or reduce a position, if necessary to ensure that markets function with integrity).

6.51 Position limits were introduced to meet a G20 objective to prevent market abuse and ensure orderly trading in commodities markets. However, the application of position limits to all contracts has meant that those that are not subject to systematic risk (such as those for niche markets or illiquid commodities) are included. This has unnecessarily restricted market trading and can prevent liquidity from developing. The combination of position limits (set by the FCA) and related powers, and of positions controls (applied by venues) has also resulted in unnecessary complexity and led to position controls often being duplicated across trading venues and the FCA.

6.52 The Bill revokes the requirement for the FCA to apply position limits to all venue-traded commodity derivatives contracts and economically equivalent OTC contracts and gives the FCA the necessary powers to establish a framework to support trading venues in setting position limits. To ensure appropriate regulatory oversight, this power will allow the FCA to require trading venues to set position limits on contracts which pose a clear threat to market integrity, and gives the FCA the ability to intervene and set limits directly on market participants where necessary.

6.53 This will allow firms to be able to trade in a less restrictive manner which will allow liquidity to develop more effectively in commodity derivatives markets. It will also allow venues to use their visibility of all positions to enforce limits which are appropriately tailored to market dynamics, while preserving protections on the most critical contracts which genuinely pose risk to market integrity.

**Methodology**

6.54 The costs and benefits have been assessed against a counterfactual of not making the changes to the existing wholesale markets regime.

6.55 The analysis in this section is informed by feedback and evidence that HM Treasury gathered from across the financial services sector during the WMR consultation process. This includes formal responses to the consultation, roundtable discussions, bilateral engagement, and additional information provided by market participants, particularly in relation to the cost of changes.

6.56 HM Treasury also consulted the FCA in the preparation of this impact assessment and in doing so, considered transaction reporting data. The government has also

reviewed FCA analysis and research papers in relation to the use of waivers for the pre-trade equity transparency regime and waivers and deferrals for the fixed income and derivatives pre- and post-trade transparency regime.

6.57 Many of the amendments to MiFID II that this Bill introduces will require the FCA to set new rules and gives them the powers to do so. The exact costs and benefits will therefore only become apparent when the FCA introduces the new rules, following its due processes.

6.58 This Bill also makes amendments to MiFID II to increase optionality, for example about where firms can trade. Both the FCA and industry representatives have confirmed that where this is the case, it is difficult to quantify the impact of any changes because doing so would require hypothetical modelling and the application of a price impact assertion. However rigorously this is approached, the resultant number would be based on a number of unverifiable assumptions, which could be easily challenged.

6.59 The analysis in this section is informed by feedback and evidence that HM Treasury gathered from across the financial services sector during the WMR consultation process. This includes the 78 formal responses to the consultation, which represent the financial sector including trading venues, trade bodies, asset managers, market data vendors, investment firms and insurance companies. A list of all respondents and summary of their feedback can be found in HMT's response to the consultation which was published on 1 March.[81]

6.60 The analysis is also informed by roundtable discussions, bilateral engagement. HMT also reached out to UK Finance and the International Swaps and Dealers Association (ISDA), ahead of the drafting the impact assessment to understand the cost of introducing the changes that are included in the Bill. Both trade associations responded to a list of questions about familiarisation costs, and the impact of changes. UK Finance and ISDA comprised of members from across the sector (exchanges, investment firms, asset manager and market makers) and provided one response on behalf of all members, therefore it is not possible to breakdown industry feedback by sub sector.

Population within scope of this policy proposal

6.61 Trading venues: There are 6 recognised investment exchanges (RIEs), 31 multilateral trading facilities (MTFs) and 21 organised trading facilities (OTFs) that are recognised/authorised by the FCA. RIEs may operate MTFs, and investment firms may operate multiple MTFs and OTFs.

6.62 Investment Firms: The category of 'investment firms' covers a wider range of firms from asset managers to market makers, inter-dealer brokers and investment advisers, and more. There are 3,348 investment firms that are authorised by the FCA which provide or perform MiFID II investment services or activities.

[81] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1057897/Wholesale_Markets_Review_Consultation_Response.pdf

6.63 Systematic Internalisers: There are currently 76 individual investment firms that have notified the FCA that they are acting as systematic internalisers.[82]

6.64 Data Reporting Services Providers: There are 8 registered Data Reporting Service Providers: 3 Approved Reporting Mechanisms (ARMs) and 5 Approved Publication Arrangements (APAs).

6.65 Market participants: are likely to be impacted by these proposals, including non-financial counterparties (e.g. energy companies who use commodity markets to hedge risks but are not authorised persons), non-regulated data providers and firms performing advisory services (such as accountancy firms and law firms). It is however not possible to estimate a figure for the number of firms in this category as the FCA does not hold this information, and it is not available from other sources.

**Policy Costs**

Transitional costs to firms

*Equity Markets*

6.66 All of the firms identified above who are active in equity markets will face familiarisation costs as a result of the changes to the equity regime that are included in the Bill. While HM Treasury can specify how many trading venues, investment firms, systematic internalisers and data reporting service providers are impacted (figures above), no figures are available for the market participants. It is therefore not possible to provide the total number of firms that fall into this category as the FCA does not hold this information.

6.67 In order to comply with the UK regime, firms are likely to engage lawyers or consultants to understand the legislation and accompanying guidance. Larger firms tend to have in-house counsel; therefore, these changes will take up their employees' time but the costs associated with this are likely to be absorbed within their existing resources. However, smaller firms are less likely to have in-house counsel, and those who don't are likely to commission an external law or consultancy firm, for which they will be charged a fee.

6.68 Once lawyers and consultants have commented on the changes, firms will then need to communicate them to relevant employees across the organisation and consider if any changes to their systems are needed. These may include technical changes to in-house systems which will incur costs for the labour involved. The technology may require input from external IT experts. All firms, regardless of size have a compliance function. In larger firms the compliance function will be split out from business units whereas in smaller firms this may not be the case and may be performed by someone whom the activity has been outsourced to. Irrespective of the business

[82] To note, to be an SI the firm must be an authorised investment firm. Currently SIs must notify the FCA based on the class of instruments for which the investment firm is an SI. This means that there is a total there are 315 SIs, but only 76 investment firms operating SIs. A full list of investment firms authorised as SIs can be found here: https://register.fca.org.uk/servlet/servlet.FileDownload?file=0150X000006gbb1

setup the compliance function or officer, will coordinate this centrally, but it is likely that input from the equity expert in the firms will be needed.

6.69 It is likely that some firms will organise training sessions for employees. Where this is the case the familiarisation costs are likely to be higher than firms that disseminate information about the changes in writing. It is not possible to quantify these because they are dependent on how individual firms operate.

6.70 For the purposes of considering the impact of the deletion of the STO, HM Treasury expects these additional familiarisation costs to mainly be faced by investment firms. This is because it is currently up to investment firms, rather than other market participants, to ensure that trades in scope of the STO take place on a venue recognised for the purposes of the STO.

6.71 The government expects investment firms to face relatively small transitional costs as a result of this change. This is because the FCA has used its temporary transitional powers (TTP) to modify the STO since the beginning of 2021. Firms have therefore already amended their systems to account for the most significant outcome of this change. HM Treasury does not expect firms to have to make any further systems changes as, the STO being deleted and not replaced, this will automatically remove an additional layer of complexity to the trade execution process. Firms will no longer be required to factor in the whether the execution location of the trade complies with the STO, therefore this will allow them to attain the best price irrespective of execution location.

6.72 Changes to the equity waiver regime are likely to result in higher transitional and familiarisation costs for firms because they are likely to impact a wide group of firms (both small and large investment firms, trading venues and asset managers). The same firms which will need to familiarise themselves with the legislative changes to the waiver regime that are included in the Bill will also have to familiarise themselves with FCA rules and guidance relating to equity markets. Additionally, it is possible that the impact of the FCA's rules will require firms to make more amendments to their internal systems and controls.

6.73 However, the full extent and cost of familiarisation will depend on the policy approach put in place by the FCA, which is not possible to know at this time. As part of developing their rules and guidance, the FCA will complete a cost-benefit analysis as per its normal processes, which will clarify the expected impact.

*Systematic Internalisers*

6.74 All systematic internalisers will face direct costs familiarising themselves with this measure. As with the changes to the equity regime, in order to comply with the changes in the Bill, systematic internalisers will need to read and understand the relevant legislation and accompanying guidance. This will involve input from internal counsel (for large firms), or advice from external lawyers or consultants (for smaller firms); work for central compliance teams and/ heads, and; input from relevant units/specialists within the organisation.

6.75 For the purposes of amendments to the definition of systematic internaliser, HM Treasury expects familiarisation and transitional costs to be limited to systematic

internalisers. It will require systematic internalisers to familiarise themselves with the legislative changes and they will also have to familiarise themselves with new FCA rules and guidance. There may be other transitional costs beyond the familiarisation costs however this is not possible to determine at this stage. The full extent of the cost, including the cost of familiarisation will depend on the policy approach put in place by the FCA, which is not possible to know at this time. However, as part of developing their rules and guidance, the FCA will complete a cost-benefit analysis as per its normal processes which will clarify the expected impact.

6.76 HM Treasury does not expect other types of firms to face familiarisation or other transitional costs because of amendments to the definition because there is a public register of systematic internalisers. Market participants tend to use this to determine who is a systematic internaliser, instead of looking at legislation or guidance. As the changes in the Bill keep the list, it is not expected that non-systematic internalisers to read this change.

6.77 However, firms who trade with systematic internalisers will need to familiarise themselves with the amendment to midpoint crossing. This will require them to read legislation, and follow the process outlined in the equity section above about engaging lawyers, compliance officers, and other relevant employees. It is not possible to provide specific numbers of firms affected, because a register of all the firms who trade with systematic internalisers does not exist.

*Fixed Income and Derivatives*

6.78 All of the firms identified above (in the population within scope of this policy proposal section) who are active in fixed income and derivatives markets will face some familiarisation costs as a result of the changes to the fixed income and derivatives regime that are included in the Bill. It is not possible for us to provide an accurate breakdown of how many firms fall into this category because the FCA's investment firms register is not broken down on an asset class basis.

6.79 In order to comply with the UK regime, firms are likely to engage lawyers or consultants to understand the legislation and accompanying guidance. Larger firms tend to have in-house counsel; therefore, these changes will take up their employee's time. However, smaller firms who do not have in-house counsel are likely to commission an external law or consultancy firm.

6.80 Once lawyers and consultants have reviewed the changes, firms will then need to communicate them to relevant employees across the organisation and consider if any changes to their systems are needed. These may include technical changes to in-house systems which will incur costs for the labour involved. The technology may require input from external IT experts. Most firms, regardless of size have a compliance unit or officer, who will coordinate this centrally, but it is likely that input from fixed income and derivatives experts in the firms will be needed.

6.81 It is likely that some firms will organise training sessions for employees. Where this is the case the familiarisation costs are likely to be higher than firms that disseminate

information about the changes in writing. It is not possible to quantify these because they are dependent on how individual firms operate.

6.82 The DTO applies to financial counterparties and some non-financial counterparties, so HM Treasury expects a wide range of persons including investment firms, trading venues, asset managers and brokers to familiarise themselves with parts of the Bill that relate to the DTO. For the changes that realign the scope of the DTO and CO and the FCA's new power to limit the scope of the DTO in certain circumstances, these persons will need to review legislation. Because the FCA has been using transitional relief to align the scope of the DTO and CO, HM Treasury does not expect that the change will result in transitional costs. HM Treasury expects firms to face transitional costs if the FCA use the power being given to them to modify the scope of the DTO, but it is not possible for us to predict these because it is dependent on how the FCA uses the power.

6.83 The Exemption from the DTO for post trade risk reduction services will require compliance officers to familiarise themselves with legislation and FCA rules. The full extent and cost of familiarisation will depend on the policy approach put in place by the FCA, which is not possible to know at this time. However, as part of developing their rules and guidance, the FCA will complete a cost-benefit analysis as per its normal processes which will clarify the expected impact.

*Commodity derivatives*

6.84 All of the firms identified above (in the population within scope of this policy proposal section)and some relevant businesses who are active in commodity derivatives markets will face some familiarisation costs as a result of the changes to the commodity derivatives regime that are included in the Bill. It is not possible for us to provide an accurate breakdown of how many firms fall into this category because the FCA's investment firms register is not broken down on an asset class basis.

6.85 In order to comply with the UK regime, firms are likely to reach out to lawyers or consultants to understand the legislation and accompanying guidance. Larger firms tend to have in-house counsel; therefore, these changes will take up their employee's time. However, smaller firms who do not have in-house counsel are likely to commission an external law or consultancy firm.

6.86 Once lawyers and consultants have reviewed the changes, firms will then need to communicate them to relevant employees across the organisation and consider if any changes to their systems are needed. These may include technical changes to in-house systems which will incur costs for the labour involved. The technology may require input from external IT experts. Most firms, regardless of size have a compliance unit or officer, who will coordinate this centrally, but it is likely that input from the commodity expert in the firms will be needed.

6.87 It is likely that some firms will organise training sessions for employees. Where this is the case the familiarisation costs are likely to be higher than firms that disseminate information about the changes in writing. It is not possible to quantify these because they are dependent on how individual firms operate.

6.88 Trading venues are likely to face the most significant transitional costs because the Bill transfers responsibility for setting position limits from the FCA to trading venues. Even though all trading venues that operate commodity derivative markets currently have position management controls in place, under the changes in this Bill they will need to play a more active role in setting limits and may need to amend their controls. This may go beyond familiarisation costs and involve operational costs however these are not possible to quantify at this stage. Only familiarisation costs can be drawn at this stage. The full extent and cost of this transition will depend on the policy approach put in place by the FCA, which is not possible to know at this time. However, as part of developing their rules and guidance, the FCA will complete a cost-benefit analysis as per its normal processes which will clarify the expected impact.

6.89 Only familiarisation costs can be drawn at this stage. The figures used to calculate familiarisation costs are only indicative. They are based on the assumption that all authorised/recognised firms will read each section but not all sections will be relevant to all firms. They also do not account for the familiarisation to costs that unauthorised/unregulated firms will face.

6.90 HM Treasury has estimated the familiarisation costs for changes to each part of the regime by multiplying the number of businesses affected by the cost per firm. The cost per firm has been calculated by multiplying the time spent on familiarisation by an assumed hourly rate of £330.[83] This is in line with other Impact Assessments that relate to legislative changes to similar areas of financial services regulation[84] and is based on an assumption that affected firms will procure the expertise and advice of an external legal firm to read the legislation and advise on the impact.

6.91 The time spent on familiarisation was calculated by dividing the approximate number of words in the instrument by 100 (based on the assumption that 100 words will be read per minute), and then multiplying by 1/60 to convert into hours. As explained above, not all firms will be affected by all the changes in the instrument but given it is not possible to breakdown how many firms fall in each category (e.g. those that are active in equities markets, those that are active in commodities markets, those that are active in both, etc.) to determine which parts of the instrument impact which firms, the total number of words in the instrument has been used each time.

6.92 There is a risk of double counting for trading venues as the majority are operated by authorised investment firms which are separately included in Table 6.A.

Table 6.A: Familiarisation costs of Wholesale Markets Review measure

83 This figure is based on the average cost of a London-based solicitor with financial services knowledge and over 4 years of legal experience.

84 https://assets.publishing.service.gov.uk/media/61364c7bd3bf7f05b7bcb562/DMA_PN_-_markets_in_financial_instruments.pdf

| Type of firm | Number of words in this instrument (rounded up to nearest 100) | Words read per minute | Hourly rate (£) | Number of businesses affected | Familiarisation costs per firm (£) (rounded to 2 significant figures) | Total familiarisation costs (£) (rounded to 2 significant figures) |
|---|---|---|---|---|---|---|
| **Trading venues** | 5900 | 100 | 330 | 58 | £320 | £19,000 |
| **Investment firms** | 5900 | 100 | 330 | 3348 | £320 | £1,100,000 |
| **Data Reporting Service Providers** | 5900 | 100 | 330 | 5 | £320 | £1,600 |
| **Market participants** | 5900 | 100 | 330 | unknown | £320 | unknown |

6.93 **As noted in Table 6.A, the total quantifiable familiarisation costs are be £1,091,520. The best estimate of the EANDCB for this measure is therefore £0.1 million.**

6.94 In total there were 78 respondents to the WMR consultation. The respondents to the consultation were representative of the entire sector and included individual investment firms (which included small and large firms as well as UK and overseas firms operating in the UK), market operators and vendors. Trade bodies that represent large sectors of the industry (buy-side and sell-side) also responded to the consultation.

6.95 The majority of changes that are being made through the Bill either delete or otherwise amend sections of legislation or delegate the setting of firm facing requirements to the FCA. For the latter changes, the costs will be dependent upon the rules that the FCA makes once it has consulted with the market and conducted appropriate cost benefit analysis. Therefore, the familiarisation costs, outlined above in table 7.A, are the only direct costs that can be quantified at this stage.

<u>Ongoing Costs to Firms</u>

6.96 Where the Bill deletes requirements and does not replace them with a power for the FCA to make new rules, HM Treasury does not expect firms to face any ongoing costs. This is because parts of the regime that are being deleted remove barriers to accessing the most liquid market or the need for firms to comply with burdensome and unnecessary requirements.

6.97 It is highly likely that firms will face ongoing costs for parts of the regime where the Bill gives the FCA new powers to set out firm facing requirements, and where the

FCA chose to use these powers. At this point in time, however it is not possible to determine how much these costs will be, or which parts of the sector will be impacted by them because it depends on what the FCA will introduce as a result of the powers they receive in this Bill.

6.98 However, as a package the changes to the UK's wholesale markets regime aim to facilitate the creation of a more agile framework. In theory this should result in lower costs for businesses going forward because the FCA will be able to adapt the regime more easily to ensure that only the firms that need to be are captured by requirements, which should allow benefits to be realised for all participants.

Transitional costs to the public sector

6.99 The FCA is using the transitional powers that were granted to it in the EU (Withdrawal) Act 2018 or supervisory powers to mirror some of the changes which this Bill will introduce. These include: modifications to the Double Volume Cap (DVC), Share Trading Obligation (STO) and Derivatives Trading Obligation, as well as the scope of the position limits regime for commodity derivatives. The changes to these requirements that this Bill introduces will therefore have a limited impact on the FCA. This is particularly the case for changes to the STO and counterparties in scope of the DTO because the changes the government is introducing will not require the FCA to the launch new consultations or develop new rules. The FCA judges that removing the DVC and replacing it with an obligation for the FCA to monitor the level of trading that happens without pre-trade transparency on a continuous basis is also unlikely to present significant implementation costs. This is because the FCA already monitors this information, therefore any costs will be continuous costs rather than new. The costs of implementing the amendments to the commodity derivatives position regime, however, are likely to be higher. This is because the FCA will need to develop new rules, which they will need to develop, consult on enforce. It is not possible to quantify these costs because they will depend on the chosen policy approach, which has yet to be determined.

6.100 All of the other changes being made to the wholesale markets regime are new and give the FCA powers to make rules in relation to certain parts of the regime. In these instances, there will be costs to the FCA in developing its approach and implementing new rules. However, it is not possible to quantify the costs because they will depend on the chosen policy approach, which has yet to be determined.

**Policy Benefits**

Benefits associated with the changes to the equity regime

*Removing the STO*

6.101 The government has engaged with industry and the FCA to understand the associated benefits of removing the STO. It will have clear benefits by leading to greater choice for investors and increasing firms' ability to get the best outcomes for their clients.

6.102 Industry representatives also noted that it will result in a simpler, more reliable regime which will make the UK more attractive as a place to invest. The change will also provide clarity about what the regime will look like when the FCA's temporary powers end, which will assist firms with their forward planning.

*Delegating the pre-trade waiver regime to the FCA*

6.103 It is not possible to quantify the benefit of the changes to the pre-trade waiver regime for equities because the impact will be dependent on the changes that the FCA make. As part of developing their rules and guidance, the FCA will complete a cost-benefit analysis as per its normal processes which will clarify the expected impact.

6.104 However, the government has engaged with the FCA and industry representatives to understand the impact of deleting the DVC, which is part of the pre-trade waiver regime. Both have agreed that it is hard to quantify the specific impact of deleting the DVC because it would require hypothetical modelling and applying a price impact assertion.

6.105 Nevertheless, trade associations have noted that it is likely to reduce execution risk, given that firms would have greater choice on where to execute and trade on behalf of a client.

6.106 Analysis in the FCA's Occasional Paper 1: 'Banning Dark Pools: Venue Selection and Investor Trading Costs'[85] also shows that trading without pre-trade transparency (such as in dark pools or venues with similar characteristics) means that investors can reduce their execution costs and increase profits for investors.

6.107 Operationally, before the FCA announced its supervisory approach to suspend it, up to 250 UK equities were capped at any one time with the consequence that firms were unable to trade them 'in the dark'. Lifting this restriction will allow the best outcomes to be achieved for clients.

6.108 As the DVC is currently suspended under temporary powers in onshored MiFIR, the change will also provide clarity about what the regime will look like when these transitional powers end, which will assist firms with their forward planning.

Benefits associated with amendments to the systematic internalisers regime

*Amending the definition of systematic internaliser*

6.109 The government has engaged with a number of industry representatives and trade bodies to understand how costly it is to perform the calculations which are currently

[85] the FCA in their Occasional Paper 1 entitled, 'Banning Dark Pools: Venue Selection and Investor Trading Costs'. The FCA's analysis shows that investors can reduce their execution costs

necessary to determine whether a firm is a systematic internaliser. Many said that they simply opt into the regime to forgo the calculations and were therefore unable to quantify the cost of performing the calculations. For these firms, amending the definition will prevent them from having to opt into the regime unnecessarily. However, all agreed that reverting to a qualitative definition will reduce burdens and costs for those firms which currently do undergo the calculations.

*Allowing midpoint crossing*

6.110 The government has spoken to a number of industry representatives to understand the benefits of allowing systematic internalisers to cross at the midpoint for all trades. The consensus from industry was that midpoint crossing will result in savings for clients because restricting it (as per the current requirement) forces one side of the transaction to accept a potentially worse price. Several industry representatives that HM Treasury officials spoke to pointed to a joint paper co-authored by AFME, CBOE and the LSE in 2018[86] on the application of the tick size regime. This paper outlines that allowing systematic internalisers to cross at the midpoint can help to improve price formation and ensure that neither buyers nor sellers are disadvantaged when trading.

<u>Benefits associated with changes to the fixed income and derivatives markets regime</u>

*Delegating the pre-and post-trade transparency regime to the FCA*

6.111 The government has not been able to quantify the benefit of the changes to the pre-trade transparency regime for fixed income and derivatives because the impact will be dependent on the changes that the FCA make. As part of developing their rules and guidance, the FCA will complete a cost-benefit analysis as per its normal processes which will clarify the expected impact.

*Realigning the DTO and CO*

6.112 The government has spoken to industry representatives to understand the benefits of realigning the counterparties in scope of the DTO and CO. As part of this engagement, market participants noted that the current misalignment leads to legal ambiguity over the scope of the obligations. They highlighted that the costs associated with this uncertainty disproportionately impact smaller financial counterparties, and certain non-financial counterparties who are caught by one but not the other. However, no firm was able to estimate the extent of the legal costs imposed by the misalignment, as these costs are encompassed in legal fees which are often bundled together with other legal services.

6.113 Industry representatives noted that clarifying the counterparties in scope of the DTO and ensuring that it is aligned with the CO will reduce ambiguity for firms and remove associated costs, including legal fees and the potential costs of having trades fail due to one of the counterparties deeming the trade to be non-compliant. It will also mitigate market disruption which can be caused by the misalignment, for

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[86] https://www.afme.eu/portals/0/globalassets/downloads/briefing-notes/2017/afme-eqt-cboe-lse-paper-application-of-the-tick-size-regime.pdf

example, due to dealers refusing to trade with affected counterparties, and the operational costs to those counterparties of onboarding to venues. Other benefits include enabling firms to align and simplify internal training material, policies, systems and procedures associated with the DTO and CO.

*Expanding the post-trade risk reduction services that can benefit from an exemption from the DTO and CO*

6.114 Expanding the exemption from the DTO and CO to transactions resulting from post-trade risk reductions services will increase the use and efficient of technical trades and as such help to reduce systemic risk (i.e. risks that could impact the overall performance of a financial market). The exact benefits will depend on what types of trades are captured which will be for the FCA and Bank to decide.

*FCA power to modify or suspend the DTO*

6.115 Giving the FCA the power to suspend or modify the DTO under certain conditions will ensure that the UK remains a stable and reliable place to trade in the event of an unforeseen event that could otherwise cause market instability and threaten market integrity.

Benefits associated with changes to the commodity derivatives regime

*Delegating the position limits regime to the FCA*

6.116 The government has engaged with industry representatives from the commodities sector, who expressed that reducing the scope of the position limits regime and transferring responsibility from the FCA to trading venues will remove unnecessary restrictions which prevent liquidity from developing. They noted this is especially the case in niche or illiquid contracts. Representatives specified that although the benefits of deeper liquidity are difficult to quantify, it tends to send a better price signal to businesses operating in physical commodities, which leads to more effective hedging against commercial risk. Furthermore, reducing the scope of the position limits regime will make it easier for non-financial entities to find counterparties to enter into hedging trades with, in order to manage their commercial risk. However, the exact benefit will depend on the nature of the framework governing position limits which the FCA put in place.

6.117 Although transferring responsibility for setting and enforcing limits from the FCA to trading venues will impose additional costs of transferring to a new system, industry representatives have noted these costs are unlikely to be high. This is because trading venues have relevant systems and expertise is already in place to operate substantial position management controls.

**Assumptions, limitations and considerations:**

6.118 It is not possible to calculate the costs or benefits of the changes which will result from the FCA’s new powers to create rules or from delegating parts of the regime to them, as the government can’t prejudge which changes the FCA will make. For

example, the FCA could amend the scope of the transparency regime so that a number of instruments are outside of scope.

6.119 It is not possible to provide specific numbers of firms affected by each section because authorisation data is not broken down on an asset class basis. This makes it impossible to specify how many market participants will have to familiarise themselves with each measure in this part of the Bill.

6.120 The only direct cost or benefit that is quantifiable from this measure is familiarisation costs. However, HM Treasury acknowledges that this does not give the full impact of the measure.

6.121 HM Treasury reached out to industry via the main trade associations to try to source more details about the quantitative impact of the changes, and in particular whether they were able to estimate the costs of additional familiarisation activities. but firms said it was impossible to provide any figures. The trade associations did however endorse the qualitative points that are made in the costs and benefits sections above.

6.122 In the absence of quantitative data, HM Treasury also asked firms how much they had spent implementing the requirements that the government is proposing to remove as part of this Bill, to measure sunk costs. However, firms said overall it was impossible to provide this because of the way their businesses were structured. Instead, they emphasised that the changes being introduced should lead to a competitive regime and cost savings in the future.

6.123 The calculation of familiarisation costs has three main limitations:

a. It is based on the assumption that firms are using an external law firm. As outlined above, large firms are likely to have access to in-house counsel, so the cost will be lower, and some firms may choose to use consultancy firms. The price is also likely to vary depending on where the lawyer/consultant advising firms are based, with London fees being the highest country-wide. This is therefore likely to be an overestimate of the cost per firm of this stage of the familiarisation process.

b. As explained above, some firms in the relevant categories will take further action, such as disseminating information to members of staff in written form or through training sessions. It has not been possible to quantify these additional familiarisation costs for the reasons set out above.

c. HM Treasury is unable to provide an estimate of the number of market participants who will familiarise themselves with the changes, for the reasons explained above.

6.124 HM Treasury considers that the impact of ii. and iii. are likely to be significantly greater than (a). and therefore, overall the figure provided is likely to underestimate the familiarisation costs of this measure.

**<u>Small and MicroBusiness Assessment (SaMBA)</u>**

<u>Number and distribution of businesses in scope of the regulation</u>

6.125 This package will reform the regulation of wholesale financial markets, which are primarily used by large institutional investors rather than smaller businesses or individual investors. However, financial services firms vary in size and do ultimately provide services to individual users which can include small and micro businesses (SMBs) who use capital markets to source capital. These individuals should benefit from enhancements to wholesale markets such as greater choice on trading location to get the best price for a trade. It is worth noting that if investment firms have costs to bear to make changes, then these costs may be passed downstream to clients.

6.126 There are six authorised recognised investment exchanges (RIEs) operating in the UK87, only one of which has fewer than 50 employees. One business authorised as a data reporting service provider (DRSP) has fewer than 50 employees (out of 5 firms authorised to provide at least one data reporting service[88]). No systematic internalisers are likely to be SMBs as this role is carried out by larger investment firms. Some investment firms and non-financial counterparties who are affected by the changes included in this measure will have fewer than 50 employees, but it is challenging to accurately quantify how many. This is because the FCA does not have access to this data, the trade associations which HM Treasury has engaged with have also not been able to give an indication.

6.127 The ONS publishes the number of small and microbusinesses based on number of employees across the UK economy.[89] The ONS breaks this down by economic activity undertaken. The subcategory (SIC number 66) most relevant to this measure relates to ' Activities auxiliary to financial services and insurance activities'.[90] For the year 2021, the total number of businesses that fall into this category (34,310) exceeds the total number of firms authorised as investment firms (approximately 3,300) but the percentage breakdown of SMBs can be applied to the number of authorised investment firms on the FCA register to give an estimation of the number impacted for this measure. According to the ONS figures, 97% of businesses in subcategory 66 have fewer than 50 employees, therefore categorising those as small or microbusinesses. Applying this 97% to the 3,300 authorised investment firms would give an estimate of 3,201 that are classified as SMBs. This correlates closely with a consultation published by the FCA in December 2020 on IFPR[91] small firms – non-systemic investment firms that are either SNI (small and non-interconnected) firms or small non-SNI firms, of which there are in total around 3,000 […]'. Applying this figure to the approximately 3,300 investment firms on the FCA register at the time would result in approximately 91% being classified as SMBs.

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87 Recognised Investment Exchanges (fca.org.uk)

88 https://register.fca.org.uk/servlet/servlet.FileDownload?file=0150X000006gbb1

89 https://www.ons.gov.uk/businessindustryandtrade/business/activitysizeandlocation/datasets/ukbusinessactivitysizeandlocation

90 Page 47: uksic2007webamend8531.pdf

91 CP20/24: A new UK prudential regime for MiFID investment firms (fca.org.uk). An investment firm must meet certain criteria to be classified as an SNI, number of employees is not one of those criteria. This criterion is set out in the FCA's handbook: MIFIDPRU 1.2 SNI MIFIDPRU investment firms - FCA Handbook

6.128 It is worth noting that some of these firms will have significant revenues despite being small in terms of the number of employees and are therefore not disproportionately impacted by changes included in this measure.

6.129 The government expects larger investment firms to face the most significant costs from these changes because they are the most active market participants. However, smaller investment who may be impacted by these changes will have to adjust their compliance process in order to accommodate them too.

6.130 As the majority of SMBs who are authorised as investment firms will focus on one asset class, unlike larger investment firms who tend to be active in all markets, they are likely to incur lower initial and ongoing costs. As an example, an SMB investment firm focussed on equities will not be directly impacted by changes to the commodity regime or to systematic internalisers and will therefore not incur any transitional costs related to complying with these as they will not be applicable. However, SMBs will benefit from changes to the systematic internaliser regime such as allowing midpoint crossing and may want to familiarise themselves with these changes which will incur a cost. Investment firms that are not SMBs will offer clients a wider array of services across multiple asset classes. Therefore, they will incur more costs as they will have to familiarise and implement changes across multiple changes included in this measure.

Do the impacts fall disproportionately on small and microbusinesses?

6.131 Many of the changes included in this measure aim to reduce burdens on firms by amending overly prescriptive requirements. Burdensome and prescriptive requirements have a disproportionate effect on SMBs as they are unlikely to have as large compliance functions as larger businesses. This means that increased resources must be dedicated to complying with these requirements which detracts those resources from other business critical functions. The changes to remove requirements should therefore be particularly beneficial for SMBs.

6.132 Most SMBs who are active in wholesale capital markets tend to be clients of larger investment firms and should therefore not face as many transitional costs. This is because most of the system changes the reforms will require will be delivered by the firms who execute the trades. For example, regional brokers are often clients of an investment bank – so the investment bank would take care of the regulatory changes related to execution. The investment bank may, however, pass on some of the implementation costs they face to the regional investor. But as the changes the government is bringing forward reduce regulatory requirements and remove prescriptive trading restrictions, the entire trading chain is expected to benefit from reduced costs when the new regime has been implemented.

6.133 When it comes to familiarisation costs, SMBs are less likely to have access to as many inhouse legal and compliance resources as larger firms. It is therefore possible that they may incur greater familiarisation and (where relevant) implementation costs as a result of employing external law firms and consultancies. It is not possible to estimate the number of SMBs that will be required to seek external counsel to assist with familiarisation and dissemination as a result of this measure.

6.134 SMBs familiarisation costs are reflected in the total costs, estimated above in Table 6.A. Narrowing these total costs to only SMBs, the estimates are shown in Table 6.B (based on the same methodology).

Table 6.B: Familiarisation Costs for Small and Microbusinesses

| Type of firm | Number of words in this instrument (rounded up to nearest 100) | Words read per minute | Hourly rate (£) | Number of businesses affected | Familiarisation costs per firm (£) (rounded to 2 significant figures) | Total familiarisation costs (£) (rounded to 2 significant figures) |
|---|---|---|---|---|---|---|
| **Trading venues** | 5900 | 100 | 330 | 1 | £320 | £320 |
| **Investment firms** | 5900 | 100 | 330 | 3201 | £320 | £1,000,000 |
| **Data Reporting Service Providers** | 5900 | 100 | 330 | 1 | £320 | £320 |
| **Market participants** | 5900 | 100 | 330 | unknown | £320 | unknown |

6.135 The limitations of these calculations are the same ones as above for Table 6.A.

Could Small and Micro Businesses be exempted while achieving the policy objectives?

6.136 As many of the changes included in this measure aim to reduce burdens on firms amending overly prescriptive requirements, the government has concluded that it would not be appropriate to exempt SMBs from this measure.

6.137 This is because although changes that are included in the Bill may result in short-term familiarisation and implementation costs, these are expected to be relatively small and in the longer term it is anticipated that the impact will be positive and reduce overall costs for all firms, including SMBs. Exempting SMBs could therefore result in them suffering higher costs of doing business in the future in comparison to larger businesses, which would be disproportionate. It is therefore not appropriate to exclude SMBs from this measure.

Could the impact on small and microbusinesses be mitigated while achieving the policy objectives?

6.138 The department has considered the potential mitigations detailed in the RPC Small and Micro Business Assessment guidance and concluded that none are relevant for this measure. This is because, as stated above, many of the changes included in this measure aim to reduce burdens on firms amending overly prescriptive requirements,

the government does not consider it appropriate to exempt SMBs from this measure.

6.139 Although changes that are included in the Bill may result in one-off familiarisation and implementation costs, these are expected to be relatively small and in the longer term the impact is expected to reduce overall costs for all firms. Exempting SMBs could therefore result in them suffering higher costs of doing business in the future in comparison to larger businesses, which would be disproportionate. It is therefore not appropriate to exclude SMBs from this measure.

6.140 HM Treasury has engaged and formally consulted industry including industry bodies which represent SMBs across the development of this measure. Feedback from this engagement has indicated that firms of all sizes are happy to meet any initial familiarisation and implementation costs to implement these changes because they believe they will result in a more effective regime and reduce costs in the future.

Wider impacts on small and microbusinesses

6.141 HM Treasury has not identified any wider impacts specific to SMBs beyond those applicable to larger firms as well.

## Central Counterparties (CCPs) in Financial Difficulties

**Problem under consideration**

7.1 As mentioned previously, central counterparties (CCPs) are a key piece of Financial Market Infrastructure which reduce the counterparty risk arising from trades between parties to a transaction, guaranteeing that transactions will be honoured if one party to the trade defaults. CCPs do this by standing between the parties of a trade, splitting the original trade into two separate transactions, such that each party trades with the CCP rather than their bilateral counterpart. This process is known as "clearing".

7.2 CCPs are integral to the functioning of financial markets, helping to make markets safer and more efficient. However, their role in helping manage risk for the market as a whole also means that a CCP failure could create significant contagion risks and trigger a system-wide financial crisis possibly requiring government intervention. It is therefore important that there is a robust regime in place for their resolution (the process by which the Bank of England (Bank), as the UK resolution authority, can intervene to stabilise the CCP, if the CCP's own recovery arrangements fail).

7.3 There are three main CCPs that operate in the UK:

a. LCH Ltd;

b. ICE Clear Europe Ltd; and

c. LME Clear Ltd.

7.4 CCPs are particularly crucial in underpinning Over the Counter (OTC) derivative markets.[92] The UK is amongst the world leaders in OTC derivative markets, with an average daily turnover of half of the global market. LCH Ltd (LCH), for instance, is exposed to almost all of the globally systemically important financial institutions and clears more than 90% of the global cleared OTC interest rate swap market, regularly clearing in excess of $3 trillion per day.[93]

7.5 Following the 2007 - 2008 financial crisis, the G20 committed to reforming the OTC derivative market, to reduce systemic risk. In 2009, leaders of countries in the G20 agreed that all standardised OTC derivative contracts should be cleared through CCPs. This has increased the volume of trades that are cleared through CCPs, which has increased both their importance and the systemic risk that they pose.

7.6 The "clearing obligation" was introduced following the financial crisis to increase the use of CCPs for clearing and to reduce the overall counterparty risk in the market; this obligation is now legally binding in the UK for certain types of products. Firms

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92 Derivatives are contracts that derive their value from an underlying asset (equities for example) or reference price (such as interest rates). They can be used to mitigate a variety of financial risks. OTC trades are those transacted bilaterally between parties, as opposed to being executed on an exchange. The market for OTC derivatives has grown over the past two decades, and as of June 2021 stood at approximately US$610 trillion in terms of outstanding notional value.

93 LCH Ltd: https://www.lch.com/services/swapclear/volumes

can access CCP's clearing services either by becoming a clearing member of a CCP, or a client of a clearing member. Clearing members are typically large financial institutions, such as banks, who can then offer clearing services to individual clients. Their clients are often medium and large sized financial and non-financial firms.

7.7 Typically, when a financial institution fails, it would be liquidated under normal or modified insolvency proceedings. However, in the case of CCPs, due to their global interconnectivity, this approach is likely to have a significant negative impact on financial stability. This is because the provision of critical clearing and settlement functions to the economy will be interrupted, having severe knock-on effects on other market participants. In the UK, a resolution regime was introduced in 2009 for banks, building societies and some investment firms, and was extended to CCPs in 2014. The regime provides powers and tools to manage financial firm failures to the UK's resolution authority – the Bank. However, the existing regime was largely designed for banks rather than CCPs, and the Bank needs additional resolution powers beyond those in the Banking Act 2009 to be able to effectively resolve a CCP in the event of its failure.

7.8 There are two instances in which a CCP might require resolution:

a. A default loss (DL). This is a loss incurred by the default of one, or multiple clearing members.

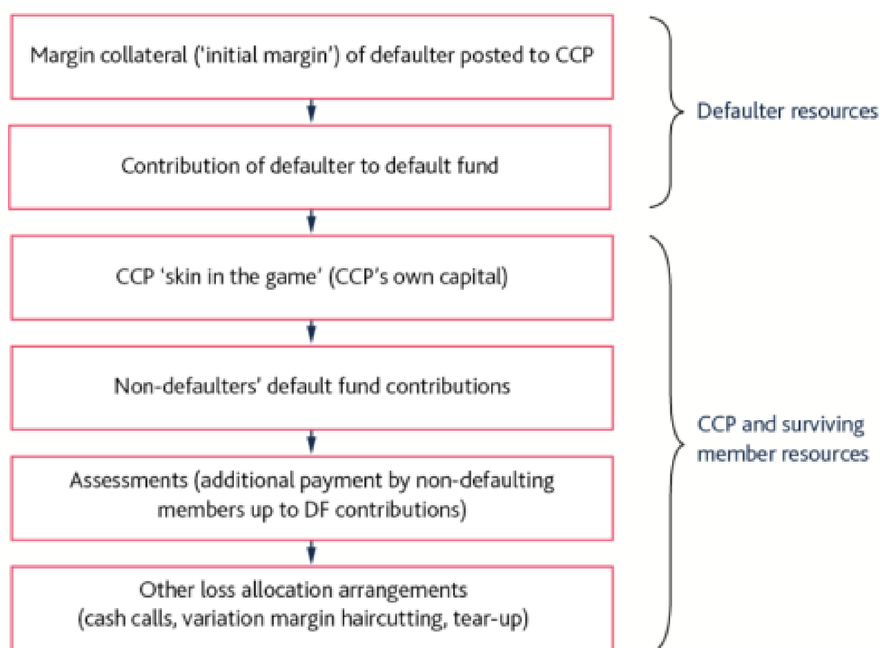
b. Non-default loss (NDL). This is a loss incurred in any other way (e.g., IT failure of a CCP).

Default losses

7.9 CCPs have extensive loss-allocation rules that specify how any losses are managed in the event of the default of a clearing member. All clearing members of a CCP must post an initial margin (IM), which is collateral based on the risk that the given clearing member poses to the CCP. The IM requirements are calculated to be able to cover the potential liquidation costs during adverse market moves if a clearing member defaults.

7.10 The clearing members are required to contribute to a mutualised pool of resources known as the default fund. In the event that a CCP experiences losses as a result of the default of one of its clearing members, the defaulter's own resources (their initial margin and contribution to the mutualised default fund) are used to absorb losses first, followed by some of the resources of the CCP (first tranche of Skin in the Game (SITG)) and the remaining clearing members' resources (the default fund). This way, as shown in Fig. 8.A, the defaulter's own contribution is exposed first, followed by part of the CCPs own capital and then non-defaulters default fund contributions are used.

Figure 8.A: Explanation of how losses are allocated[94]




7.11 CCPs are designed to be able to manage the default of an individual member, and should have sufficient prefunded resources to be able to manage the default of their two largest members using:

a. The defaulting clearing members initial margin and default fund contribution.

b. The CCPs own resources (SITG).

c. The CCP's default fund (other member contributions).

7.12 Losses that exceed this amount would require the clearing members to provide additional funds. If these are insufficient, the CCP may have to terminate some of its contracts with clearing members in an attempt to restore a matched book, close the clearing service, and allocate outstanding losses to clearing members. If a CCP is unable to manage a default loss without threat to its continuity, or its actions risk adverse consequences for financial stability, then resolution may be required.

Non-default loss

7.13 The continuity of critical clearing services may also be threatened as a result of the CCP experiencing a non-default loss (NDL), where the CCP incurs a loss without one of its members defaulting, which exceeds the resources available to the CCP (e.g., as a result of a cyber-attack). If there is a NDL the CCP is not able to use its default fund. In such a case, resolution would be required to avoid the CCP entering insolvency to

[94] Figure 8.A sourced from 'The Bank of England's approach to tiering incoming central counterparties under EMIR Article 25' - https://www.bankofengland.co.uk/-/media/boe/files/paper/2021/boes-approach-to-tiering-incoming-central-counterparties-under-emir-article-25-sop.pdf)

ensure that the CCP could continue its critical functions, thus limiting disruption to capital markets.

**Rationale for intervention**

7.14 Since the 2007-08 financial crisis, firms have been required to clear an increasing range of products through CCPs. This has increased both the volume of trades passing through CCPs and their scale and interconnectivity, making them a greater source of financial risk.

7.15 Of the 30 Globally Systemic Important Banks (GSIBs), as determined by the Financial Stability Board (FSB) in 2020[95], 25 own, or partially own, at least one clearing member of a UK CCP. As over 80% of GSIBs use UK CCPs in some manner, this indicates that there would be a high-level of market disruption in the event of a disorderly failure.

7.16 In 2017, the FSB published "The Guidance for Central Counterparty Resolution and Resolution Planning"[96], which complements the FSB "Key Attributes of Effective Resolution Regimes"[97] and sets out guidance on effective approaches to the resolution of CCPs specifically. It recommends additional powers beyond those currently in the Banking Act 2009, to support the effective resolution of a CCP.

7.17 Expanding the UK's resolution regime for CCPs in line with FSB guidance will ensure that the government fulfils its wider commitment to influencing and implementing international standards. A robust resolution regime for CCPs will help to ensure that the UK remains competitive and a world leader for clearing services, which will bring positive impacts to the UK financial system.

**Policy Objective**

7.18 At present the UK CCP resolution regime (as detailed in the Banking Act 2009), provides the Bank with some stabilisation powers in the event of a CCP failure. However, the regime is not sufficient to allow the Bank to effectively manage the failure of a CCP in a way that minimises the impact on the wider financial system: in particular, it lacks the tools that the FSB guidance suggests it should have to be able to perform this role effectively. The current powers constrain the Bank's ability to minimise instability across the financial system and protect public funds. Expanding the CCP resolution regime and giving the Bank appropriate powers will require primary legislation.

7.19 The circumstances that would require CCP resolution are "tail risk" events, and as they are extremely unlikely, potential causes and impacts cannot be predicted with certainty. Therefore, while the Bank currently possesses some tools to resolve a

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95 FSB 2020 list of globally systemically important banks (GSIBs) https://www.fsb.org/wp-content/uploads/P111120.pdf

96 FSB Guidance on Central Counterparty Resolution and Resolution Planning https://www.fsb.org/wp-content/uploads/r_141015.pdf

97 FSB Key Attributes of Effective Resolution Regimes for Financial Institutions https://www.fsb.org/wp-content/uploads/r_111104cc.pdf

CCP in a limited number of hypothetical scenarios, it does not have the appropriate level of flexibility to resolve a CCP in the most efficient way, nor in a way which would allow it to fully limit financial stability risks.

7.20 The current CCP resolution regime does not permit a CCP to enter resolution on the grounds that continued recovery action by the CCP could present a threat to financial stability. Therefore, the current regime could prevent the Bank from acting in a timely fashion to minimise any adverse effects on financial stability, increasing the risk to public funds and confidence in the financial system.

7.21 The current resolution powers available to the Bank allow them to transfer the property or ownership of a CCP to for example another CCP or firm. However, the Bank remains reliant on the powers available under the CCP's rulebook (or internal recovery regime) to rematch the CCP's book and allocate losses. Resolving a CCP under the current regime could present a heightened risk to public funds as, in the absence of an appropriate set of resolution powers, taxpayer money may be required to: absorb losses; recapitalise the CCP to the minimum required regulatory standards; and/or to compensate creditors, stakeholders or clearing members. Therefore, without intervention to enhance the UK's current CCP resolution regime, there are foreseeable circumstances in which public funds could be significantly impacted during the resolution of a CCP.

7.22 In particular, if there were a default loss, the current regime does not contain effective powers for the Bank to be able to return the CCP to a matched book in a DL scenario, meaning that any position taken on by one counterparty is always offset by an opposite position taken on with a second counterparty. This ensures that the CCP is not directly holding a market position. Delays in crystallising losses could result in greater overall losses for the CCP.

7.23 Additionally, unlike for banks, the current regime does not provide a general No Creditor Worse Off (NCWO) safeguard which would ensure that creditors are eligible for compensation if they are left worse off in resolution than under the counterfactual. The lack of the safeguard, limits the protections of clearing members, and other CCP creditors, and may increase uncertainty in the event of a resolution event.

7.24 Given the globally systemic nature of CCPs, and the vital role that UK CCPs specifically have in the global clearing market, they are subject to the highest standards of regulation. The new proposals seek to provide powers and tools in line with FSB guidance, and therefore ensure the UK is compliant with international standards.

**Description of Options Considered**

7.25 Option 0 (Do nothing) - The Bank has limited powers to manage the resolution of a CCP. Under this option, the Bank would not have the flexibility to resolve a CCP in the most effective way possible. If a CCP were to fail, there could be contagion across the financial system.

7.26 Option 1 (Preferred Option) - Expanded CCP resolution regime. The preferred approach is to legislate for an expanded resolution regime as it will provide the Bank

with the appropriate powers to manage a CCP failure in the most appropriate way. This regulatory option will also allow for the Bank's early intervention on the grounds of financial stability and help to minimise contagion risks to wider sectors and markets. The legislative approach would also allow the implementation of a No Creditor Worse Off safeguard, which cannot be introduced without primary legislation.

7.27 Option 2 (Non-preferred) - Non-regulatory approach. Currently, the actions that the Bank can take are limited to the measures that CCPs have specified in their rulebooks. The Bank could work with CCPs to change their rulebooks so that the Bank could ensure that the necessary resolution tools and powers are available to the Bank under a CCP's rules. The adequacy of the rulebooks would need to be periodically assessed, and close co-operation would be necessary. If this process was successful, it would emulate some of the policy outcomes of the proposed legislation. However, this approach would have disadvantages compared to the legislative approach. The Bank would not be able to pre-emptively intervene on the grounds that there was an emerging threat to financial stability. The Bank would also have less control over the form and usage of tools and could therefore less effectively prevent contagion to wider markets. This approach would also not include an explicit NCWO safeguard for CCP resolution. There would be no guarantee that if losses in resolution were greater than in insolvency, creditors would be entitled to compensation equal to the difference.

**Outline of preferred policy**

7.28 It is not possible to predict the scenario in which a potential resolution will occur, as this has never happened in the UK. The proposed regime expansion seeks to provide the Bank as the UK Resolution Authority with the appropriate tools and powers needed to manage a CCP failure effectively in either a DL or a NDL scenario. In order to give the Bank these powers and tools, it will require amendments to the Banking Act 2009. The powers being brought forward in the Bill broadly fall into three categories: general powers, loss-allocation powers and safeguards, and other powers.

7.29 In expanding the CCP resolution regime, it will ensure that the Bank has the necessary powers to, in the event of a DL or NDL scenario: (i) stabilise a CCP so that it can continue to provide its critical clearing services, (ii) prevent contagion spreading across the financial system, (iii) ensure that CCPs clearing members bear the losses arising from the failure which will protect public funds. Each of the powers and tools that will be available to the Bank have a specific effect. However, in the event of a resolution, it is unlikely that any tool would be used in isolation. Together the proposed powers and tools form a robust regime which gives the Bank the flexibility to effectively meet its objectives.

General powers

7.30 The following general powers will be legislated for in the Bill:

a. Removal of material impediments to resolvability. This power would enable the Bank to require a CCP to make changes to remove potential barriers to resolvability identified by the Bank. Whilst the Bank expects that CCPs will make changes on a voluntary basis, this power will be a valuable backstop;

b. Conditions and timing for entry into resolution and engagement between authorities. Some measures within a CCP's recovery plan could have an impact on wider markets.[98] This power would enable the Bank to place a CCP into resolution before the CCP's own recovery measures have been exhausted, on the condition that continued recovery actions by the CCP would likely 'compromise financial stability'. The Bank will be required to consult HM Treasury on whether this new resolution condition is met;

c. Lockdown or deferral period on the payment of dividends, buybacks or variable remuneration. This power would enable the Bank to temporarily restrict or prohibit any remuneration of equity for CCP shareholders in severe circumstances, including if there is a rapid deterioration in the financial situation of the CCP, and it was therefore at risk of failing. It would be available as an early intervention measure, but also after the CCP has entered resolution to ensure that all resources are directed to compensation payments and replenishing public funds where these have been used as a last resort, should either be necessary;

d. Power to suspend termination rights. This power would give the Bank the ability to temporarily stop any right to early termination of participation by a clearing member that arises as a result of a CCP being placed in resolution. This would help stabilise the clearing services offered by the CCP and ensure that the Bank has access to the largest possible pool of resources for loss absorbency, thereby limiting risks to public funds;

e. Power to take control of the CCP. This power would enable the Bank to take control of a CCP without having to rely on its existing property or share transfer powers. This would allow the Bank to enforce the CCP's rulebook more easily to stabilise the CCP and ensure continuity of the critical clearing service in resolution without the legal and operational risk of conducting a property or ownership transfer;

f. Power to remove and replace directors. This would provide the Bank with the power to direct a CCP to remove or replace directors and senior executives and appoint temporary managers in severe circumstances, as the PRA and FCA are already able to do for other types of financial services firms. Pre-resolution, it would only be used if there was a rapid deterioration in the financial situation of the CCP and it was at risk of failing, or if there was an infringement by the directors or senior executives at the CCP; and

98 Given the interconnectivity of CCPs, insolvency could have an impact across a wide number of financial markets, including but not limited to securities, derivatives and equity markets.

g. Power to return the CCP to a matched book. The Bank will have the power to return a failing CCP to a 'matched book' to ensure that it does not continue to be exposed to losses generated by the positions of the defaulting clearing member(s).[99] The Bank would have the flexibility to perform a full or partial termination of contracts, depending on the scenario and the potential wider impacts on financial stability. To provide clearing members and end users with greater certainty of how these powers would work in practice, the Bank will set out how it intends to use these powers in the event of a CCP failure.

Loss allocation powers and safeguards

7.31 The following loss-allocation powers and safeguards will be legislated for in the Bill:

a. No creditor worse off (NCWO) safeguard. This safeguard would ensure that creditors of the CCP would have the right to compensation should they be worse off in resolution than they would have been in the absence of resolution action had the CCP entered insolvency. Under this measure, only the direct costs that creditors would have experienced in the absence of resolution action being taken would be included in the valuation of the NCWO counterfactual (i.e. only the losses they would have been allocated in line with the CCPs rulebook). Following this valuation, compensation could take the form of, depending on the compensation order: proceeds from the delayed enforcement of a clearing member's obligations; claims on a share of the CCP's future profits; revenue resulting from the sale of the CCP; equity in the CCP; or potentially, as a last resort, public funds;

b. Deviation from a CCP's rules and arrangements. These measures would allow the Bank to direct a CCP to deviate from a CCP's rules and arrangements. In some circumstances, it could be appropriate for the Bank to direct the CCP to deviate from their rulebook if relying on the processes under CCP's rulebook would result in significant adverse impacts on financial markets;

c. Second tranche of skin in the game. As part of their resilience measures, UK CCPs are already required to hold a ring-fenced tranche of their own capital often referred to as SITG. The new powers will require the CCPs to hold a second tranche of SITG sitting after the prefunded default fund, requiring CCPs to hold a greater amount of capital for loss absorption. This will reinforce the incentives for CCPs to conduct robust risk management and ensure that their default fund is appropriately sized. The size of this second tranche will be based on a number of factors, such as the size of the CCP and the risk that it is clearing. The Bank will be empowered to specify the exact methodology for calculating the amount of second SITG CCPs will be required to hold;

d. Power to perform variation margin gains haircutting (VMGH). In resolution this would give the Bank the ability to reduce (potentially to zero) the variation margin payments that a CCP would otherwise be required to make

[99] A matched book ensures that the that the CCP has a buyer and seller for every trade that they are a part of.

to clearing members whose positions have gained value. The tool would allow the Bank to haircut beyond the quantum, or length of time, provided for in the CCP's rulebook to provide additional loss absorbing capacity in resolution. Assuming cash calls would have been performed before the use of VMGH is envisaged, without this tool resources in excess of the limit on VMGH contained in the CCP's rulebook would only be accessible following the closure of the critical clearing service (as would occur in recovery). This tool would only be available for use in a default loss scenario; and

e. Further powers to generate additional loss absorbing capacity. The Bank will have powers to write down unsecured liabilities (more likely to be used in the case of non-default scenarios) and a statutory cash call power which enables the Bank to collect contributions from clearing members (in the case of both default loss and non-default loss scenarios). The Bank will be able to allocate losses through the mechanism that it judges least disruptive. There will be safeguards to stop the Bank writing down certain liabilities (e.g initial margin) when using its write-down power. To enable clearing members to be aware of the level of resources that they might have to pay under the cash call power, an individual clearing member's contribution will be capped at two times an individual member's prefunded contribution to the default fund in a default-loss scenario, and three times in a non-default loss scenario.

Other Powers

7.32 The Bill will also introduce other powers related to the expanded CCP resolution regime:

a. Power to delay enforcement of a clearing member's obligation in resolution. This power enables the Bank to delay enforcement of a clearing member's obligations in resolution should such enforcement during the resolution of a CCP present a risk to financial stability. The Bank would have the power to enforce outstanding obligations resulting from a delay in enforcement at any time up to 18 months after the resolution, if at the relevant time the reasons for refraining from their enforcement no longer exist. If the Bank does not enforce an outstanding obligation within this 18-month period, the obligation will lapse at the end of it;

b. Replenishment. This power would enable the Bank to use statutory loss allocation tools (VMGH, cash calls and write down powers) to recapitalise the CCP and replenish its prefunded resources, not just to absorb losses. This tool could also be used to repay public funds, if they have been called upon as a last resort; and

c. Compensation. If a clearing member is compensated, either as a result of the NCWO safeguard or otherwise, compensation could take the form of proceeds from the delayed enforcement of a clearing member's obligations; claims on a share of the CCP's future profits; profits resulting from the sale of the CCP' equity in the CCP; or potentially as a last resort public funds. The use of public funds for compensation would be the last resort and subject to explicit consent from HM Treasury. If a clearing member is compensated,

they should not be mandated to compensate their clients. The relationship between a clearing member and their clients is a private contractual agreement, and this will govern any rights and obligations regarding compensation being paid from the clearing member to its client. Clients will only be entitled to a direct claim when they are a direct creditor of the CCP.

**Methodology**

7.33 The nature of any resolution is highly scenario dependent and estimating the contributions that clearing members may be asked to provide in a resolution cannot be predicted with a high level of certainty.

7.34 Overall, the proposed expansion to the resolution regime for CCPs will have a net benefit to the UK's financial system. The proposals are designed to ensure that in the event of a CCP failure, CCPs and clearing participants make a financial contribution during a resolution, to stabilise the CCP and mitigate risks to financial markets, whilst also protecting public funds. These contributions will ensure that critical clearing services can continue, which will limit contagion to wider sectors and markets, and therefore reduce the likelihood of a system wide crisis. The introduction of an expanded resolution regime will enable the Bank to manage costs that would already be incurred in a resolution in a more efficient way, and where possible, limit these.

7.35 The costs are highly scenario dependent. While the costs below are divided into "transitional" and "ongoing", in practice the "ongoing" costs will only materialise if use of resolution powers are necessary. It is HM Treasury's assessment that any transitional costs are likely to be marginal, and the ongoing costs are contingent costs, which are highly likely to be less than if a CCP was failing and was not placed into resolution. Further to this, a CCP resolution is a very low probability event, so it is unlikely that these costs will arise. In assessing costs it should also be noted that the maximum loss cannot be inflicted by multiple tools (e.g., in a combined DL and NDL scenario, if the CCP's prefunded default fund has been used to manage the default, a further loss cannot be inflicted on clearing members via writing down the default fund liabilities, as this resource has already been depleted).

Population within scope of this policy proposal

7.36 The three major UK CCPs and their clearing members will be impacted by these changes. The CCP clearing members are typically (but not exclusively) large banks.

7.37 Further details will be set out in the secondary legislation that is enabled by the Bill. HM Treasury will provide a further impact assessment in each instance where it makes such secondary legislation. However, to inform an assessment of the Bill the government has set out the possible costs and benefits. It is important to note however that the below costs and benefits are illustrative and any costs and benefits to firms will be contingent on the exact nature of the secondary legislation.

7.38 At the point of secondary legislation, and in line with the government's approach to better regulation under the Better Regulation Framework, HM Treasury will make efforts to further consult on and understand the potential further impacts of this measure, including through appropriate stakeholder engagement. More detailed

qualitative and quantitative cost-benefit analyses are expected to be covered in the IAs accompanying the relevant secondary legislation enabled by the Bill. HM Treasury will also engage with the RPC, prior to the submission of IAs produced to accompany future secondary legislation where appropriate.

**Policy Costs**

Transitional costs for firms

*Familiarisation costs for CCPs*

7.39 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 any regulator rules.

*Second Skin in the Game*

7.40 CCPs are going to be required to hold an additional layer of capital or 'Second Skin in the Game' (SSITG). All UK CCPs currently hold resources in excess of the minimum SITG requirement under the European Market Infrastructure Regulation (EMIR), which forms part of retained EU law in the UK following the UK's Exit from the EU.

7.41 The specific amount of SSITG capital requirement will not be stipulated in legislation. The amount of SSITG CCPs will be required to hold will be set and calculated by the Bank after the legislation is in force. The Bank will consult on the level of the eventual SSITG it wishes to set and complete an associated cost-benefit analysis prior to the rules coming into effect. It is therefore not appropriate to attempt to quantify this impact as part of this analysis.

Contingent costs

7.42 These costs are contingent in the sense that they will only arise in the event of a CCP failure.

*Contingent costs to the Bank*

7.43 The introduction of a power for the Bank to remove impediments to resolvability could see the Bank involved in novel and more complex work compared to now if this power were to be used. However, the Bank judges this would not be a significant resource requirement for them. In addition, a similar power already exists in the bank resolution regime, and therefore the Bank already has some existing institutional knowledge about how using this power could work. It may be that a 0.5 FTE of senior analyst/manager would be needed should this power ever be enacted, at an approximate cost of £50,000 – £100,000 per year to the Bank.

*Contingent costs to CCPs*

7.44 Under the NCWO counterfactual, if any creditor of the CCP, including the CCP's equity holders, are left worse off as a result of action by the resolution authority, they are entitled to compensation equal to the difference compared to the relevant

counterfactual. This ensures that there are no increased costs for creditors in resolution.

7.45 In DL scenarios, compensation payments to clearing members are limited to losses in excess of the loss the clearing member would have incurred under the CCP's recovery tools (in line with the NCWO safeguard). The Bank will always aim to limit losses in a resolution, meaning clearing members are left no worse off as a result of resolution action, than they would be if the CCP entered insolvency. Where costs exceed the insolvency counterfactual, the resolution authority may make claims on a share of the CCP's future profits or equity in the CCP (amongst other things) to compensate clearing members, however, given that this is a highly unlikely and situation dependant scenario it is not possible to provide an accurate estimate of these costs.

7.46 If there was a NDL scenario, after all loss absorbing resources have been exhausted, the CCP would enter insolvency. In resolution, the Bank may, by use of the statutory resolution tools, require additional resources from the clearing members and unsecured creditors of the CCP. Under the NCWO insolvency counterfactual, if required by the Resolution Authority, the CCP would pay compensation in relation to this 'additional loss' to clearing members in the form of equity or a share of future profits.

*Contingent costs to clearing members*

7.47 Loss allocation tools: In both DL and NDL resolution scenarios, under the NCWO safeguard, if clearing members bear a higher cost as a result of resolution action, then they are entitled to compensation. This ensures there are no increased costs for clearing members in resolution compared to the CCP applying its recovery measures in full or entering insolvency. Therefore, costs to clearing members, compared to the CCP going into insolvency, are assumed to be zero.

7.48 Full or partial termination of contracts: As set out above, the Bank would be given the power to terminate contracts (whether full or partial) in order to rematch a CCP's book. This would be performed at a commercially reasonable value to avoid using this tool as a mechanism for loss allocation. Therefore, the termination will not impose direct losses on impacted clearing members.

7.49 Replenishment: As outlined previously, the Bank would also have the power to use statutory loss allocation tools (VMGH, cash calls and write down powers) to generate funds to recapitalise the CCP and replenish its prefunded resources, not just to absorb losses. This tool could also be used to repay public funds, if they have been called upon as a last resort. This power is not available under the counterfactual. As such, the costs borne by clearing members under these powers in resolution will be additional costs for which the clearing members may be compensated with equity or a share of future profits of the CCP. In respect of any excess losses borne by a clearing member, it would be eligible for NCWO compensation.

**Policy Benefits**

Ongoing Benefits

*Reduced likelihood of a system-wide financial crisis*

7.50 The proposals are designed to give the Bank the appropriate powers to effectively resolve a CCP in the event of a failure. CCPs are already required to have financial resources available to be able to survive the default of their two largest clearing members. Even at times of market stress, CCPs have shown high levels of resilience. Therefore, as there are limited historic cases of CCP failure, it is difficult to accurately estimate the impact that a CCP failure would have on the financial system.

7.51 The table below provides the IM held at the three CCPs during Q3 2020.[100] These figures could be considered the minimum potential future exposures of the CCP to its participants, and as a result could be an indicator of the magnitude of risks managed by a CCP. For all three CCPs, the total initial margin was in the billions of pounds, and LCH's initial margin exceeds £200 billion. However, the future exposures of a CCP could far exceed the scale of the IM it holds, therefore highlighting the need for a robust regime for its resolution.

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[100] The data in the table above has been sourced from CCPs' CPMI-IOSCO public disclosures at end Q3 2020

ICE: https://www.theice.com/clearing/quarterly-clearing-disclosures

LCH: https://www.lch.com/resources/ccp-disclosures

LME: https://www.lme.com/en/Market-data/Reports-and-data/LME-Clear-reports/CPMI-IOSCO-Disclosure)

Table 7.A: Total Initial margin held by CCPs in the UK

| CCP | Total IM held Q3 2020 (GBP) |
|---|---|
| LCH Ltd | £211,195,063,352 |
| ICE Clear Europe Ltd | £62,434,734,496 |
| LME Clear Ltd | £6,611,061,598 |
| Total | £280,240,859,446 |

7.52 This demonstrates the scale of UK CCPs and the potential risks they could pose if there was a disorderly bankruptcy. The planning, prevention and early intervention measures that form part of the proposal reduce the probability of a crisis occurring, and as a result, reduce the potential negative knock-on effects of a crisis affecting the financial sector.

7.53 It is not possible to provide an accurate estimate of the costs of a CCP failure, and no publicly available estimates exist for the additional losses and costs which could result from the contagion and market uncertainty that would follow a CCP failure. However, given the interconnectivity of CCPs across financial markets, the Bank estimates that the impact could be substantial and risk contributing to a banking crisis. The present value of output losses in a typical banking crisis has been estimated by the Bank to be 75% of GDP.[101]

*Protection of public funds*

7.54 A significant benefit of this policy is the limitation of the potential use of public funds to support a failing CCP. The financial services sector will bear the costs of any CCP failure before the government intervenes. Currently, if the resources which CCPs and/or clearing members are contractually required to provide in the event of a CCP failure are insufficient to cover the loss, then as a last resort the government may decide that it needs to step in to preserve financial stability. These public funds could be used for loss allocation and recapitalisation of the failed institution.

7.55 Under the proposed regime, public funds would be better protected. The new tools and powers provide the Bank with the ability to allocate losses and provide CCPs shareholders and clearing members with more certainty during a resolution – public funds will only be accessible in the most extreme and extraordinary cases. Additionally, the ability of the Bank to take resolution action sooner (under the proposed financial stability trigger) may limit the overall negative impact of a CCP failure, which could prevent there being a knock-on effect to public funds.

101 Bank of England: https://www.bankofengland.co.uk/knowledgebank/will-there-be-another-financial-crisis

*Reduced moral hazard for CCPs*

7.56 As there is no expectation that the government will intervene in markets to save CCPs, this will increase the incentive for CCPs and clearing members to ensure that CCPs conduct appropriate risk management and have robust recovery measures in place, including an appropriately sized default fund. This will reduce the moral hazard associated with the government being able to save the CCP.

*Maintaining and attracting business to the UK*

7.57 Expanding the regime has a potential pro-competitive impact, given that the UK would be amongst the few jurisdictions to legislate for a bespoke CCP resolution regime which implements the most recent FSB guidance, and could therefore attract businesses to clear through UK CCPs. Given how instrumental the UK has been in helping to develop FSB standards, it is important that the UK implements these standards as soon as possible. A failure to do so could present a reputational risk to the UK and have a resulting impact on UK competitiveness.

**Assumptions, limitations, and considerations**

7.58 Where costs have been estimated (e.g., initial margin, capped cash calls, VMGH), these figures have been modelled on data from 2020 Q3. The period 2020 Q3 was chosen as there were periods of significant and abnormal volatility in Q1/ Q2 of 2020. The Q3-2020 point-in-time figures are considered by HM Treasury to be sufficiently representative. In general, initial and variation margin, default fund and SITG values are reasonably stable, so an annual average is unlikely to substantially differ from the Q3 2020 point-in-time figures.

**Small and MicroBusiness Assessment (SaMBA)**

Number and distribution of businesses in scope of the regulation

7.59 This measure primarily applies to CCPs and clearing members, neither of which are categorised as small or microbusinesses. There are currently 3 CCPs based in the UK, with membership ranging from 46 to 322 clearing members. All three CCPs are part of large multinational groups with well over 50 employees. Specific firm-level data on the number of employees is not available but based on public financial statements none of these firms could be classed as small businesses as they all have annual turnover over £10m.[102]

7.60 No future CCP established in the UK is expected to be a SMB - any new entrant to the market would likely be one part of a large financial services group, as is the case with the current set of firms. The services that CCPs provide are technically complex and would require a level of investment to set up and run which is likely beyond the means of any SMB. The nature of the markets in which these firms operate also does

102 https://www.lch.com/system/files/media_root/2021_lch_group_stat_accounts_ey.pdf;
https://www.ice.com/publicdocs/clear_europe/ICE_Clear_Europe_Limited_Statutory_Accounts_2021_UK_GAAP.pdf;
https://www.lme.com/about/governance/lme-clear-governance/Financial-statements;
https://www.euroclear.com/content/dam/euroclear/investor-relations/annual-reports/2021/Documents/IR4311_EUI_Financial_Statements_2021.pdf

not lend itself to small-scale competitors. Due to the strong economies of scale in the clearing market for instance, the global market for specific products can be dominated by an individual firm and it would be challenging for a SMB to compete in terms of liquidity or pricing.

7.61 Clearing members are also overwhelmingly likely to be large businesses falling outside the definition of SMBs as these tend to be large financial institutions active in trading complex derivatives on behalf of clients. This is also in part due to the capital requirements imposed on them by CCPs as criteria for them becoming clearing members. Capital requirements vary within CCPs depending on the market a clearing member operates in, but are a minimum of $10 million for 2 of the CCPs based in the UK, and a minimum of £5 million for the other.

7.62 If SMBs are to be affected at all, it would be an indirect impact in their capacity as potential clients of clearing members. Neither HM Treasury nor the Bank hold data which would provide the total number of clearing member clients, and in turn what proportion of those clients are small or microbusinesses. Both financial services and non-financial services firms may be clients of clearing members, although indicative data focused on the Euro area suggests that the majority of direct clearing member clients are banks, investment funds, and other financial institutions. Applying the assumption that the same holds true for the UK, HM Treasury notes that for the year 2021, ONS reported that there are 19,640 firms under the relevant category of 'financial service activities; except insurance and pension funding' (SIC 64).[103] Of these, 98% (19,285) of firms can be classified as SMBs with the total number of employees being less than 50. However, this figure is likely to not be representative of clearing member clients, as many of the firms are not engaged in financial market activity which requires clearing. This could be for a number of reasons. For example, they may not enter into derivatives contracts covered by the clearing obligation or in the trading of equities or financial products.

7.63 The number of non-financial services firms which would be clients of clearing members and a SMB is likely to be small. This is because there are some exceptions in place for non-financial services firms that exempt them from clearing in certain circumstances (for example, if the volume of derivatives they engage in does not pass a specific threshold). SMBs are unlikely to exceed these thresholds.

Do the impacts fall disproportionately on small and microbusinesses?

7.64 The resolution tools legislated for in the Bill do not in of themselves impose losses or burdens on clients of clearing members, who are the most likely relevant party to fall within the definition of SMBs, but rather provide the Bank, as Resolution Authority, with the tools required to resolve a CCP in significant financial distress, in order to continue the provision of critical clearing services. The NCWO safeguard provides for compensation for creditors of a CCP (primarily shareholders and clearing members), if they are left worse off in resolution than if the CCP had gone into insolvency. The

103 https://www.risk.net/journal-of-financial-market-infrastructures/7820071/a-descriptive-analysis-of-the-client-clearing-network-in-the-european-derivatives-landscape

only potential exception to this is the use of the write-down power – the risk of which the government has mitigated. Further detail is provided below.

7.65 If there is any cost of resolution action on SMBs (with the exception of the write-down power, the mitigation for which is detailed below), then it will be an indirect impact, as a result of a clearing member passing on to its clients 'losses' allocated to the clearing member by the Bank during the resolution of a CCP. The extent to which a clearing member could do this would depend on the terms on which clearing services are provided. These are set out in agreements between clearing members and their clients, and these negotiated contractual arrangements between the parties are likely to be subject to the requirements of conduct regulations. This will include those set by the FCA for UK based clearing members, which are likely to include, for instance, the requirement that clearing services shall be provided on reasonable commercial terms. The NCWO safeguard should also ensure that a clearing member does not bear greater losses in resolution than it would have done if the CCP had gone into insolvency, thus reducing the risk of there being excess losses (i.e., more than would have been borne if resolution action had not been taken) which could be passed down to clients (who could potentially be SMBs).

7.66 Given CCPs are systemically important, the expanded resolution regime will promote and protect financial stability within the UK by ensuring that a CCP failure is managed correctly and effectively, and ensuring public funds are protected. The aim of this legislation is to protect the wider financial system, which is an indirect benefit for all businesses who interact with the financial system in any way, including SMBs who may be more susceptible that other businesses to a system-wide crisis of the type that the expanded CCP resolution regime seeks to prevent.

7.67 The government, therefore, does not anticipate that these proposals will affect SMBs disproportionately.

Could small and microbusinesses be exempted while achieving the policy objectives?

7.68 As previously noted, HM Treasury does not anticipate that the legislation will directly impact any SMBs. As such there is no clear justification for a broad exemption from the policy for SMBs. The Bank's powers are designed to affect a CCP and its clearing members, and any other contractual arrangements held by clearing members are out of scope of this legislation.

7.69 As mentioned above, the legislation includes a specific exemption for small enterprises from the Bank's new power to write down unsecured liabilities. This power essentially allows the Bank amend the value of (or 'write-down') unsecured liabilities. Given this deals with a broad range of potential liabilities, the government has included a broad exemption, to ensure that SMBs (who, without this, could find a larger proportion of their balance sheet affected by this rule) are exempt from the power. This exemption defines a small enterprise as a businesses which employs fewer than 50 people and whose annual turnover does not exceed £10 million. This will ensure that the Bank cannot write-down unsecured liabilities owed by the CCP to a small business, to ensure these firms are not disproportionately impacted by the use of this power.

Could the impact on small and microbusinesses be mitigated while achieving the policy objectives?

7.70 As mentioned, where the government and the Bank have considered that there may be scope for a small business to be affected through the use of the write-down power, the government has mitigated that risk by exempting small businesses.

7.71 There is no further required mitigation, as the legislation only directly affects CCPs and their clearing members (i.e., larger businesses and financial institutions). The only way to fully mitigate all risk would be to include a provision prescribing for the actions of clearing members in relation to their clients. However, the government considers that this would be disproportionate. As stated above, FCA regulated clearing members (and non-UK situated clearing members regulated in other jurisdictions) would continue to be subject to conduct regulations which include proportionate obligations, such as the requirement for a clearing member to provide clearing services 'on reasonable commercial terms.' As such the government concluded that specific provisions related to clearing members and their contractual relationships with a range of clients would risk adding unnecessary complexity to the regulatory framework.

Wider impacts on small and microbusinesses

7.72 As above, resolution tools will primarily impact CCPs and clearing members, neither of which are categorised as SMBs. The only way SMBs could be affected would be if they were a client of a clearing member of a CCP in resolution.

7.73 There is nothing within the proposals that affects such clients disproportionately in a CCP resolution, particularly when compared to the counterfactual of a CCP entering insolvency and the discontinuation of critical clearing services. SMBs will benefit from an outcome which sees an increased positive impact on financial stability, which is far more likely under the measures. SMBs will also benefit from the reduced likelihood of a system wide crisis, which these measures also seek to achieve.

## Insurers in Financial Difficulties

**Problem under consideration**

8.1 Insurers provide vital services to the UK economy by allowing businesses and households to manage risk, and by supplying finance through the investment of premiums. The UK insurance sector is robustly supervised, well-capitalised and resilient to shocks. However, insurers may still experience unexpected financial difficulties, and in rare cases may become insolvent.

8.2 The PRA is responsible for prudential regulation of UK-authorised insurers and has powers in relation to insurers in financial distress or insolvency. The PRA's preferred strategies for dealing with an insurer in financial difficulties are typically solvent run-off, whereby the PRA prevents an insurer from writing new insurance business and the insurer's existing contracts are 'run-off' (paid out or allowed to expire) over time, and/or portfolio transfer, whereby an insurer's policies are transferred to another viable insurer under Part VII of FSMA.

8.3 The UK's current insolvency arrangements for insurers are a modified version of the UK's standard corporate insolvency arrangements, augmented in some places with bespoke provisions specifically designed to manage the failure of an insurer. This framework is predominantly contained in the Insolvency Act 1986, FSMA, and associated secondary legislation.

8.4 Although the current arrangements for insurers in financial difficulties are effective and provide the UK authorities with some bespoke tools for managing an insurer in distress, several gaps in this framework have been identified. These gaps may increase the risk of undesirable outcomes for policyholders, particularly in the unlikely event of large or multiple insurer failures. There are several areas in which the existing arrangements should be made more robust:

a. Section 377 FSMA: Lack of clarity. Section 377 FSMA provides a power for the court to reduce the value of one or more of the contracts of an insurer which has been 'proved to be unable to pay its debts.' However, this power has never been used, leading to uncertainty around how the procedure would operate in practice. In addition, the power is currently only available as an alternative to making a winding-up order[104], limiting options for intervening at an earlier point. These issues create barriers to the use of a procedure which could, in certain circumstances, lead to preferable outcomes for policy holders and other creditors compared to insolvency.

b. Section 377 FSMA: Lack of supervision. The current legislation does not provide for any administrator or other office-holder to oversee the write-down procedure. This differs from other restructuring and insolvency procedures.

c. Section 377 FSMA: Access to Compensation. The FSCS can compensate eligible policy holders if their insurer fails. However, there is no provision for

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[104] This is otherwise known as compulsory liquidation where a company is unable to pay its debts.

payments to be made to policyholders if the value of their claim is reduced by the court under section 377 FSMA. Similarly, if an insurance policyholder's policy were reduced, and the insurer later failed triggering FSCS compensation, the FSCS would likely only protect the lower value of the claim. This could be detrimental to policyholders if their claim is reduced under section 377 of FSMA, and it reduces the usability of the current power.

d. Risks from Contractual Termination Rights. Insurers will hold both supply contracts (contracts to supply a business with goods or services), such as those for business-critical utilities; and financial contracts, such as lending agreements. Both types of contracts can include 'ipso facto' clauses, which allow counterparties to terminate the contract if the insurer enters insolvency or restructuring proceedings[105], even if the insurer continues to meet its obligations to that counterparty (such as making payments on time). Early termination of supply contracts could disrupt the business activities of a struggling insurer, hindering attempts to facilitate a run-off or otherwise avoid a disorderly failure. Early termination of financial contracts could suddenly expose an insurer to significant risks, leading to further financial difficulties.

e. Risks from Life Insurance Surrender Rights. Certain life insurance policies include an investment element and accrue equity (or 'cash value') over time. These policies typically include 'surrender' clauses allowing policyholders to terminate their contract early in return for a proportion of its cash value. When a life insurer is known to be in financial distress, policyholders may choose to surrender their contracts over concern that they will lose value, creating a situation similar in motivation and effect to a 'run' on a bank. These policy surrenders could make it more difficult to estimate an insurers liability and slow down or destabilise the recovery/insolvency process, particularly where negotiations are taking place for a portfolio transfer to another insurer.

**<u>Rationale for intervention</u>**

8.5 The UK's current arrangements for insurers in financial difficulties are effective and sufficient to manage the vast majority of potential failure scenarios in an orderly manner. However, the government has identified areas where pre-cautionary changes would make the UK's arrangements more robust. These amendments are expected to reduce the likelihood of significant destruction of value in the event of insurer failure, which would have a detrimental impact on policyholders.

8.6 The issues identified in relation to the early termination of contracts and the surrender of life insurance policies can be viewed as a market failure due to a collective action problem. For example, in the case of policy surrenders,

[105] The Insolvency (Protection of Essential Supplies) Order 2015 created a statutory override of 'ipso facto' clauses pertaining to certain insolvency procedures. However, these provisions only applied to supplies of utilities and IT goods contract. CIGA extended these protections to cover all types of supplies. However, supplies to insurers (among other categories of financial services firms) were explicitly excluded under CIGA, meaning that insurers are still vulnerable to the termination of certain supply contracts.

policyholders acting individually to minimise their perceived risk (by surrendering their contracts) may hinder recovery of the insurer, ultimately leading to worse outcomes for all policyholders. Similarly, service providers making use of early termination clauses due to concern around an insurer defaulting may precipitate that default by undermining the insurer's operational continuity. Government intervention may therefore help to produce preferable outcomes for all parties.

8.7 The issues identified with the current section 377 FSMA arise from a lack of detail in primary legislation. As such, government intervention through legislation is the only appropriate intervention, and voluntary measures or other non-legislative interventions are not appropriate.

8.8 In addition, the proposed amendments would align elements of the UK's insolvency arrangements to relevant elements of international standards for insurer resolution[106], which have been developed in recent years. As well as representing best practice, closer alignment to internationally agreed standards is expected to reinforce confidence in the UK's insurance sector, and in the UK as a world-leader in financial regulation.

**Policy objective**

8.9 This measure has several policy objectives, including to:

a. Promote continuity of cover for policyholders by allowing earlier intervention when an insurer is in financial difficulty;

b. Reduce costs and value destruction associated with insurers undergoing insolvency or restructuring procedures, thereby improving outcomes for creditors;

c. Further protect policyholders by clarifying the application of the FSCS;

d. Reduce costs to industry by unlocking additional loss absorbency; and

e. Maintain and enhance public and international confidence in the UK insurance sector.

**Description of Options Considered**

8.10 Option 0 (Do nothing) - Failure to change the UK's insolvency arrangement would leave in place unclear and ambiguous policy, which may not be able to reduce the risk of significant destruction of value and detrimental outcomes to policyholders and other creditors when insurers enter financial difficulties. In the event of large or multiple coinciding insurer failures, doing nothing would also fail to reduce the risk of wider disruption to the UK's financial system and risk to public funds.

8.11 Option 1 (Preferred Option) - The government is planning to make a series of targeted amendments to the UK's arrangements for insurers in financial difficulties, implemented via primary legislation (although there will be subsequent changes to

[106] 'Resolution' means action taken by a designated authority (in the UK, the Bank of England) to manage the failure of a financial institution, as an alternative to allowing it to enter insolvency proceedings.

regulator rules and guidance in some areas). The government has considered whether the policy objectives could be met through changes to regulator rules rather than primary legislation. However, as the UK's insolvency arrangements are set out in primary legislation, this is the only option that would meet the policy objectives set out above; changes limited to regulator rules would not be able to fully meet the policy objectives outlined above.

**Outline of preferred policy**

8.12 The preferred policy is for a series of targeted amendments to the primary legislation governing the UK's insurance insolvency arrangements for insurers. The Bill makes five amendments to the current insolvency arrangements for insurers:

a. Clarifying and extending the court's power to order a write-down (reduction) in an insurers liabilities under section 377 FSMA. As set out above, section 377 FSMA provides a power for the court to reduce the value of one or more of the contracts of an insurer which has been 'proved to be unable to pay its debts', instead of making a winding-up order. The Bill will omit and then enhance the section 377 FSMA write-down power, which will include setting in legislation the liabilities that are in scope of the write-down; and introducing a new moratorium on certain types of legal process while an insurer is undergoing a write-down, preventing creditors from taking legal action to recover debts (as long as these debts were incurred before the moratorium came into force).

b. Enabling the court to appoint a write-down manager to support a write-down under the amended section 377 FSMA. The Bill will introduce a new position of 'write-down manager', an officer of the court tasked with helping to design, advise the court on, and monitor a court-ordered write down. A write-down manager would not be 'in possession' of an insurer, however they would be empowered to make recommendations to the insurer's directors, and to apply to the court for directions where appropriate. A write-down manager will remain in post until a write-down is terminated.

c. Ensuring the FSCS is able to appropriately protect eligible policyholders following a write-down under the revised write-down power. There is currently no provision for policyholders to receive compensation or other support if the value of their claim is reduced by the court under Section 377 FSMA. If the insurer were later to fail, any FSCS compensation may be based on the lower, written-down value of the claim. The Bill will amend the rules governing FSCS compensation to ensure that: the FSCS is able to make 'top-up payments' to eligible policyholders whose claims are written down under the revised write-down power (the FSCS's normal compensation limits will apply); and the compensation due to protected policy holders will be based on the original, pre-write-down, value of the claim, rather than on the reduced claim. These amendments will ensure that protected policyholders are no worse off following a write-down than they would have been if the insurer had failed. The rules governing FSCS compensation for eligible insurance policyholders are set by the PRA, in its Rulebook, and the Bill will

therefore require the PRA to amend its rules to achieve these outcomes. The PRA's Rulebook changes will be subject to the usual rule-making disciplines (i.e., consultations)107.

d. Introducing a temporary moratorium on early termination clauses found in supply and financial contracts held with insurers. Insurers in financial difficulties face risks from the early termination of both financial and supply contracts, even if they continue to meet contractual obligations. The Bill will introduce a temporary moratorium on early termination rights where these arise solely as a result of an insurer's financial distress. The moratorium will only apply if the insurer continues to meet all of its contractual obligations, including making any ongoing payments in full and on time. In administration, the moratorium will by default continue to apply for the duration of the administration. In the case of a write-down, the moratorium will apply for six months from the date that the write-down comes into effect. In both cases, the court will be able to grant an extension or to terminate the moratorium early. Certain contractual arrangements within financial contracts will be excluded from the scope of the moratorium, to ensure that counterparties' risk management practices are not adversely affected.

e. Introducing a temporary stay on surrender clauses contained in certain life insurance policies. Life insurers in financial difficulties may also face risks from policy surrenders motivated by concern regarding the insurer's financial position. To mitigate these risks, the Bill will introduce a temporary stay on life insurance surrender rights while an insurer is undergoing certain procedures. While the stay is in force, policyholders will not be able to exercise early surrender rights, although small, regular withdrawals which form part of a policyholder's normal income will be permitted. The right to transfer a policy to another insurer will also be suspended while the stay is in force. If the stay risks causing financial hardship for an affected policyholder (for example, a policyholder who needs to access the value of their policy early due to bereavement), they will be able to apply for a hardship exemption.

**Methodology**

8.13 For some of these proposals, such as those arising from familiarisation, the relevant counterfactual is simply the one in which these proposals are not introduced. However, when considering the use of procedures and tools which these proposals will introduce, assessing the counterfactual requires considering which alternative insolvency or restructuring procedures would be used in the absence of these proposals. Typically, insurers in financial difficulties will enter administration, and so administration is used as the counterfactual when assessing various costs.

107 https://www.prarulebook.co.uk/.

8.14 This assumption is appropriate given that the proposed test for use of the amended write-down power will more closely align with the current test for entering administration – that the insurer in question 'is, or is likely to become, unable to pay its debts.' Given this test, it is highly unlikely that an insurer would make use of the write-down procedure in circumstances where it would not currently make use of an insolvency or restructuring procedure. Furthermore, administration is the most commonly used procedure for insurers in financial difficulties, making this the most appropriate counterfactual when considering, for example, application and legal costs.

8.15 The government has primarily relied on qualitative analysis of the expected benefits of these proposals. This is in large part because the losses experienced by policyholders, creditors and wider industry in the event of an insurer failure (and the extent to which these proposals might mitigate those costs) will always be highly case-specific, and cannot be meaningfully quantified given the lack of historical data on the section 377 FSMA write-down power. However, the government has sought to provide indicative estimates where appropriate.

8.16 The government also explicitly sought industry views on the costs associated with this measure in its public consultation108 which ran from 20 May 2021 to 13 August 2021, during which time the government received 9 written responses109. The government has considered the information received from respondents in the drafting of this impact assessment.

Population within scope of this proposal

8.17 The Bill measures will apply primarily to insurers operating in the UK. There are currently 595 authorised insurers in the UK.[110] All of these insurers will be in the scope of the proposals, although the government expects that the core proposals (namely, the revised write-down power) will not be appropriate for all insurers. In particular, the government expects the write-down power to be more appropriate in the life insurance sector, where continuity of cover is of greater important for policyholders.

8.18 Other firms, primarily those supplying or financing insurers, could also be affected by the tools and procedure introduced under these proposals (mainly the write-down power and the moratorium). The government does not hold, and is not aware of, any data on the number of firms supplying or financing insurers. However, the

108 https://www.gov.uk/government/consultations/amendments-to-the-insolvency-arrangements-for-insurers-consultation

109 The government received consultation responses from the following: The Association of British Insurers; The Centre for Commercial Law, University of Aberdeen; The City of London Law Society Insolvency Law Committee; Freshfields Bruckhaus Deringer LLP; The International Underwriting Association of London; Interpath Advisory; Mazars LLP; PricewaterhouseCoopers LLP; and Teneo Restructuring. On its webpage, the Association of British Insurers notes it 'has over 200 members companies, including most household names and specialist providers'.

110 Including UK-authorised insurers, Gibraltar-authorised insurers, and insurers incorporated in the European Economic Area (EEA) with deemed Part 4A permission in the Temporary Permissions Regime (TPR) or Supervision Run-Off (SRO). Source: Bank of England / PRA.

average insurer may have between 10 and 20 suppliers.[111] Since some of these suppliers may overlap (i.e., provide service to more than one insurer), the population of affected suppliers is likely to be at the low end of the range c.6,000-12,000. It is important to note that, unlike insurers, which will incur direct costs, costs for suppliers and counterparties are indirect, and will only arise in the rare event that an insurer enters financial difficulties.

**Policy Costs**

8.19 The Bill measures introduce a number of different tools to assist in managing the failure of an insurance firm. Each of these will lead to different costs for businesses and the public sector. In addition, there will be some costs linked to the package of measures as a whole. The costs have been grouped into general costs across all of the measures, and then each of the measures as set out in the "outline of preferred policy" section above.

Transitional costs across all measures

*Familiarisation costs for insurance firms*

8.20 Directors and managers of insurers are likely to require familiarity with these measures, given their roles may necessitate compliance or action under the provisions introduced by this measure. There are currently approximately 5,000 individuals carrying out senior management functions in the UK insurance sector112. The majority of these individuals are unlikely to require in-depth familiarity with these proposals nor be required to disseminate this knowledge to others within their organisations; as such, it is assumed that the time requirement of formal training, per individual, will be half a day (1.75 – 3.5 hours). A review of the pricing of insolvency training courses offered by R3 (a trade association for UK insolvency and restructuring professionals) suggests such training is likely to cost between £109 and £328.[113] This range gives a total estimated cost of formal training across 5,000 senior managers of £0.55m to £1.64m.

8.21 Senior managers will also incur opportunity costs from attending training. The Annual Survey of Hours and Earnings[114] 2020 dataset finds (mean) average hourly earnings for corporate managers and directors to be £29.13. In 2019, Eurostat

111 Insolvency Service management information indicates that, historically, the average liquidation has involved around 10 creditors, providing a rough proxy for number of suppliers. While insurers in the UK tend to be larger than the average company, they may also be more likely to bring services in-house, and rely on fewer external suppliers. As such, an estimate of 10-20 affected suppliers per insurer has been selected for the analysis.

112 Source: Prudential Regulation Authority authorisations data.

113 R3 offer an Introduction to Insolvency training series, priced at £1,000 for members and £1,500 for non-members, over 16 hours. Using this price per hour of training gives a low estimate of £109 (based on 1.75 hours of training at member pricing) and a high estimate of £328 (based on 3.5 hours of training at non-member prices).

114 https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworkinghours/datasets/occupation2digitsocashetable2.

estimated the non-wage component to be 18% of total labour costs in the UK.[115] This implies that the cost to business of employing managers and directors is, on average, £34.37 per hour. The total cost of employing a worker will be an underestimate of the opportunity cost to business of losing an hour of their time to training for any profit-making firm. However, given the difficulties in estimating the true loss of revenue associated with losing employees' time to training, the total cost of employment stands as an acceptable proxy for true opportunity cost. Therefore, using the training time estimates above, the estimated opportunity cost to business from training an individual manager for these measures is £60.15 - £120.30. For 5,000 senior managers, this gives a total associated cost to industry of £301,000 – £602,000 (rounded to three significant figures). The midpoint of this range – £451,000 – is the best estimate.

*Familiarisation costs for wider industry*

8.22 Insolvency Practitioners (IPs) will also need to spend time familiarising themselves with the measures. IPs are regulated individuals acting as officers of the court in relation to formal insolvency procedures for individuals and businesses. As of January 2021, there are 1288 IPs taking appointments116. However, insurer insolvency is a specialised field117 and evidence from past cases of insurer insolvency suggests that IPs are likely to be drawn from one of five firms: PricewaterhouseCoopers (PwC), Ernst & Young (EY), Grant Thornton, Interpath Advisory, and Teneo Restructuring. These five firms currently employ 131 registered IPs118. As some IPs outside of these firms may also need familiarity with these proposals, it is assumed that a range of 100-200 IPs will need training.

8.23 IPs are expected to require greater familiarity with these proposals than insurance managers. As such, it is estimated that the required training will take between a half and full day (3.5 – 7 hours).[119] Using the same method to estimate formal training costs as used above, combined with the range of 100-200 IPs needing training, gives a total training cost to IPs of £21,900 to £131,200.

8.24 IPs will also incur opportunity costs from lost earnings while undertaking training. A 2013 report by the Insolvency Service120 found the average hourly chargeable rate for a senior (i.e., at partner/director level within their firm) IP to be £366. Applying

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115 https://ec.europa.eu/eurostat/statistics-explained/index.php?title=File:Hourly_labour_costs_in_euro_in_2019.png

116 See the Annual Review of Insolvency Practitioner Regulation 2020 (https://www.gov.uk/government/publications/insolvency-practitioner-regulation-process-review-2020/annual-review-of-insolvency-practitioner-regulation-2020).

117 Additionally for this reason, the government anticipates that these individuals will not be required to disseminate their knowledge or provide to others. As such, the government does not expect any additional familiarisation costs.

118 Source: the Insolvency Practitioner Directory (https://www.gov.uk/find-an-insolvency-practitioner).

119 This is based on the expected length and complexity of the legislation. It matches the familiarisation costs for the Corporate Insolvency and Governance Act (2020): https://publications.parliament.uk/pa/bills/cbill/58-01/0146/SIGNED%20-%20IA%20Insolvency%20and%20Corporate%20Governance%20Enactment%20Stage.pdf

120 Insolvency practitioner fees: a review (https://www.gov.uk/government/publications/insolvency-practitioner-fees-a-review).

GDP deflators gives a rate of £408 in 2019 prices, suggesting the opportunity cost to an individual IP from undertaking training could be in the range £1,428 to £2,856. However, an IP's chargeable rate is likely to be a significant overestimate of their true hourly earnings, given that they will not be carrying out chargeable work for clients at all points. As such, it is appropriate to halve this estimate, and use the range £714 - £1,428. Combining this estimate with the range of 100-200 IPs gives a total opportunity cost of training to IPs of £71,400 to £285,600.

8.25 Table 8.A below summarises the estimated familiarisation costs for industry associated with these proposals. These are one-off transitional costs, and direct costs of the proposals.

8.26 **As noted in Table 8.A, the familiarisation costs are estimated to be between £944,000-£2.66m, with a best estimate of £1.8m. The best estimate of the EANDCB for this measure is therefore £0.18m.**

Table 8.A: Familiarisation costs for industry

| | | **Cost Range (£, 3 s.f.) (best estimate in brackets)** | | |
|---|---|---|---|---|
| | | **Cost of Formal Training** | **Opportunity Cost** | **Total** |
| **Individual** | **Insolvency Practitioners** | 219 - 656 | 714 – 1,430 | 933 – 2,080 |
| | **Insurance Directors and Managers** | 110 - 328 | 602 - 1204 | 170 - 448 |
| **Across Industry** | **Insolvency Practitioners** | 22,000 - 131,000 | 71,400 – 286,000 | 93,400 – 417,000 |
| | **Insurance Directors and Managers** | 550,000 - 1.64m | 301,000 – 602,000 | 851,000 – 2.24m |
| | **Total** | 572,000 – 1.77m | 372,000 – 888,000 | 944,000 – 2.66m (1.80m) |

8.27 Professionals other than IPs, managers, and directors may need familiarity with these measures, recognising in particular that the parties eligible to take on write-down manager appointments under these proposals could include actuaries and 'suitably qualified insurance professionals' as well as IPs. However, it is unlikely that other parties would need in-depth familiarity with these proposals other than on a case-by-case basis. As such, it is assumed that other professionals will receive on-the-job training where relevant, with no significant additional cost.

8.28 Employees of public sector bodies, including but not limited to HM Treasury, the PRA, FCA, FSCS and the Insolvency Service, may also need to familiarise themselves with these proposals. However, any related costs are likely to be minimal given that key senior staff have been involved in the development of these proposals, and are therefore already familiar with their content, and that any training required is likely

to be delivered on a case-by-case basis or included in regular ongoing or introductory training packages, at little to no additional cost. As such the government considers it appropriate to treat familiarisation costs to public sector workers as nil.

Ongoing costs

*Costs to the court system*

8.29 The Bill measures introduce several new (or amended) types of applications which the courts can be asked to consider, for example applications for a write-down order under the revised write-down power and associated applications for variation/termination of the write-down. The creation of additional court procedures could increase the number of applications requiring consideration by the courts, leading to higher operational costs for the court system.

8.30 However, under the counterfactual in which these new procedures are not introduced, it is still expected that (different) applications will be put to the court. For example, if an insurer experienced financial distress, it is highly likely that rather than undergoing a write-down and appointing a write-down manger (as they might if these measures were introduced), the insurer would enter an alternative procedure such as administration or liquidation. These procedures entail their own costs for the courts, including in relation to associated applications, and therefore the additional burden on the courts from the use of the amended write-down power is assumed to be nil.

8.31 In contrast, the measures that introduce entirely new court applications (relating to the proposed new moratorium on certain contractual termination rights and stay on life insurance policyholder surrender rights) would apply during administration as well as during a write-down. As such, these applications are more likely to be genuinely additional in comparison to the status quo and could potentially increase the burden on the courts.

8.32 Since the year 2000, 11 UK-regulated insurers have defaulted[121], giving an annual rate of insurer insolvencies of approximately 0.5. It is reasonable to assume therefore that the proposed moratorium and stay will be used 0.5 times per year after the introduction of these proposals, given that administration is the most commonly used procedure for insurers in financial distress. Applications to extend, vary, or end the moratorium or stay are not expected to be common, given that both will terminate automatically after six months (or, in the case of administration, when the administration period ends). As such, it is appropriate to assume that each use of the moratorium will entail 1 such application, and each use of the stay will entail 1 such application. However, a range of 0-3 applications for each is modelled, giving a

121 Over this time period 27 insurers operating in the UK have defaulted, but in only 11 of these cases was the Financial Services Authority (until 2013) or PRA (since 2013) the home-state regulator. Insurers with non-UK home-state regulators are unlikely to make use of UK insolvency procedures, and so 11 is the most appropriate figure to use when considering the likely frequency of use of the proposed moratorium and stay.

range of 0-6 per insurer insolvency, given that both the moratorium and stay will both trigger upon an insurer applying for administration.

8.33 Court consideration of an application in relation to the moratorium or stay is not expected to take more than half a day of court time. A 2018 Law Society report[122] estimated the daily operational cost of running a court at £2,692, including both staff and judiciary costs and estate costs. As such the cost of hearing this type of application is likely to be approximately £1,375. The government therefore estimates the additional costs to the court service from this type of application as between £0 and £8,247, with a best estimate of £2,749. Combining this with the annual insolvency rate of 0.5 calculated above gives a best estimate annual cost of £1,375.

8.34 The same methodology is more difficult to apply in the case of applications for exemptions from either the moratorium or stay. This type of application is expected to require only 0.5 - 1 hours of court time given its relative simplicity, implying a cost per application of £172 - £344 (on the assumption that daily court costs can be divided by 8 to give an hourly cost). However, any estimate of the proportion of counterparties and policyholders expected to use this exemption process in each case would be largely speculative and potentially misleading. As such, there is no attempt to further quantify the total costs arising from this type of application. However, the government expects these costs to be negligible given the infrequency of insurer insolvencies, the safeguards built into the proposed moratorium and stay which should limit recourse to the exemptions process, and the ability of certain parties to approve exemptions from the effect of the stay on surrender rights without referral to the court.

Costs associated with clarifying and extending the court's power to order a write-down in insurers liabilities under section 377 FSMA

*Costs for Insurers: Debt Issuance*

8.35 Insurers issue unsecured debt (i.e., they borrow), both for general business financing purposes and in order to fulfil regulatory capital requirements. Certain debt issued by insurers will be within the legal scope of the amended write-down power.

8.36 The proposed amendments are intended to make the write-down power more accessible and increase the likelihood of it being used in future. As such, it is possible that holders of unsecured debt issued by insurers (or bondholders) might consider themselves more likely to suffer losses if the insurer experiences financial difficulties and the write-down power is used, and consequently demand higher interest rates on their lending to insurers to compensate for that risk. These bondholder expectations could lead to insurers' facing higher costs to issue unsecured debt than had been the case previously.

8.37 However, HM Treasury's central case assumption is that there will not be an increase in insurers' debt issuance costs resulting from introduction of these measures, meaning there is no EANDCB related to this potential cost of this measure. The key reason is that any increase in perceived risk for bondholders is expected to be small

[122] https://www.lawsociety.org.uk/en/topics/research/cost-of-day-in-court-new-analysis-by-law-society

relative to the status quo, given that the court will not be able to sanction a write-down under the proposed amendments unless it assesses that use of the procedure is likely to lead to a better outcome for an insurer's creditors as a whole (i.e., including its bondholders) than the most likely alternative. As such, a write-down will only be sanctioned where it is likely to maximise the funds available for distribution to creditors, making it unlikely that any bondholders will receive less following a write-down than they would have under an alternative insolvency or restructuring procedure (and the risk of entering insolvency, or indeed a write-down under the current section 377 FSMA, should already be reflected in the yield on the relevant unsecured debt).

8.38 Relatedly, Credit Rating Agencies (CRAs) do not expect these measures to have notable impacts on the credit rating of debt issued by insurers. In May 2022, Standard & Poor's (S&P) noted the proposed measures "would have little to no impact on our ratings on insurance companies based in the UK, or on their debt".[123] S&P expects most UK insurance groups' bonds to be out of the legal scope of this expansion of write-down powers, although S&P note that some UK-based mutual insurers do issue from an operating entity or a financing entity (which then on lends to an operating entity) and are likely to be covered by these amended powers. Overall, this assessment would support a view that, as the measure is not perceived to change the creditworthiness of insurers, it is unlikely to affect their borrowing costs.

8.39 In addition, given the lack of exact equivalents to section 377 FSMA or the amended write-down power in other jurisdictions, HM Treasury has been unable to find relevant international comparisons to suggest an increased likelihood of any increase in funding costs resulting from the introduction of this measure.

8.40 However, in the interest of transparency, HM Treasury has considered what the scale of increased costs of debt issuance for insurers could be if this central case assumption were incorrect. This is considered below.

Additional cost analysis

8.41 As set out above, there is a lack of exact equivalents to the proposed amended write-down tool. However, in terms of other tools used to impose losses on unsecured creditors, the write-down tool is arguably comparable to 'bail-in' tools which are common in banking resolution regimes (including in the UK).[124]

8.42 For the purpose of this additional analysis, HM Treasury therefore considers that it is sensible to use the costs of debt issuance in the banking sector as a proxy to

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[123] https://www.spglobal.com/ratings/en/research/articles/220523-how-will-proposed-amendments-to-the-u-k-s-insolvency-regime-affect-insurers-12382908#:~:text=The%20proposed%20amendments%20to%20existing,(with%20a%20fixed%20charge).

[124] In the European Union, a bail-in tool was introduced by the Bank Recovery and Resolution Directive (Directive 2014/59/EU), which was implemented in the UK primarily through amendments to the Banking Act 2009. Equivalent tools exist in other jurisdictions, including the United States.

estimate costs to the insurance sector. This aims to illustrate costs which may arise under a highly conservative worst-case scenario.

8.43 Immediately following reforms made after the 2008 financial crisis, the data available suggested the costs of debt issuance in the banking sector varied depending on jurisdiction. For example:

a. In Denmark, bank debt prices moved to a materially higher level (100 basis points) than other Scandinavian jurisdictions following the introduction of a bail-in regime.[125] However, it is not clear how much of this increase can be attributed to the introduction of bail-in versus other factors particular to the Danish banking sector.

b. Conversely, US banks saw only small and transient changes to funding costs following the introduction of the Dodd-Frank Act in 2010, which included a tool capable of imposing losses on creditors in an equivalent way to bail-in. The four largest US banks saw their funding costs increase by an average of 20 basis points, but then broadly return to their initial levels over the next 3 months.

c. The European Commission's 2012 impact assessment for its legislative proposal on the Bank Recovery and Resolution Directive (BRRD) drew on a JP Morgan survey, which estimated that the funding costs associated with liabilities subject to bail-in would rise by 87 basis points (based on a bank given an A rating by a CRA).

8.44 As set out in a December 2019 Bank of International Settlements (BIS) paper, funding costs following the introduction of bail-in have continued to vary.[126] The paper aimed to ascertain whether a "bail-in risk premium" (BIRP) existed with regards to costs of issuing debt for senior bail-in bonds above that of comparable senior non-bail-in bonds across four jurisdictions (continental Europe, Japan, the UK and the US) between early 2016 and year end 2018. The hypothesis set out in the paper is that bail-in bonds will exhibit a positive BIRP (i.e., these are more costly for banks to issue) to compensate investors for the risk of being bailed in.

8.45 The data presented in the BIS paper depicts a mixed picture. The paper identified an average BIRP of around 20 basis points across a large sample of bail-in bonds issued by global systemically important banks (G-SIBs) and other large banks for the period from March 2016 to end-2018.

8.46 The average BIRP for UK banks was found to be 29 basis points, which compares to the respective European, Japanese and US averages of 30, 2 and 14 basis points.[127] This suggests that even under a worse case estimate, any increased costs levied on

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125 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/271121/Bail-in_IA.pdf

126 Bank of International Settlements, Monetary and Economic Department, "Believing in bail-in? Market discipline and the pricing of bail-in bonds", Working Paper No. 831, December 2019. Available here: https://www.bis.org/publ/work831.pdf

127 These figures are set out in Table 2 of the Bank for International Settlements (2019) paper on p.13.

insurers for issuing debt is likely to be lower than some post-2008 estimates set out above.

8.47 HM Treasury judges that the BIS analysis, despite being partly based on data that is up to five years old, is still materially relevant for the purpose of this additional analysis. This is because there are similar characteristics of the debt issuance market in the UK between the study being conducted and now, for example:

a. Average annual net issuance of capital by UK firms was approximately the same over the period of the study (2016 – 2018) and more recently. The annual average was approximately £50 billion over the periods 2019-2021 and 2016-2018.[128]

b. The credit risk premium over the risk-free rate[129] was at similar levels over the period of the study (2016 – 2018) and more recently. The annual credit risk premium for 'Other Financial Institutions' was 2.4% compared to 2% over the two periods, 2016 – 2018 and 2019 – 2021, respectively.[130]

8.48 While these figures are useful for estimating what changes to funding costs could be as a worst-case estimate following the introduction of an amended write-down power for the purpose of transparency, there are further reasons to expect that any increase (if HM Treasury's central case assumption was incorrect) will be smaller than those increases related to the introduction of bail-in powers.

8.49 Firstly, the bail-in (or equivalent) tools included in bank resolution regimes are typically designed to operate in tandem with regulatory requirements for firms to hold funds which can absorb losses through bail-in. Under BRRD, firms are subject to a minimum requirement for own funds and eligible liabilities (MREL), representing resources which can absorb losses and provide for recapitalisation in resolution. By contrast, insurers will not be required to issue new debt earmarked for loss absorption as a result of these proposals. While the price of servicing existing levels of debt could naturally rise (e.g., due to interest rate changes), there will be no wider change in funding structures or volumes of debt issuance which could affect pricing (further supporting HM Treasury's central case assumption). As such, any change in the cost of debt issuance for the purpose of this additional analysis is likely to be significantly smaller than those observed or predicted in relation to bail-in.

8.50 Secondly, in the UK, bail-in is a 'preferred resolution strategy' for some banks and therefore the most likely tool for the Bank of England ("the Bank") to deploy, as

128 Source: Bank of England Database – Capital Issuance.

129 That is, the amount that the market requires to cover: (a) the effects of expected defaults due to the failure of the borrowing party to discharge its contractual obligation and (b) compensation for assuming the risk of default.

130 Source: S&P Global, HIS Markit, Iboxx indices, Iboxx Sterling Financials; Bank of England Yield Curves, and Bank of England calculations.

resolution authority, were that bank to fail.[131] In contrast, the amended write-down procedure will only be one of various tools available to the UK authorities to deal with an insurer in financial difficulties, alongside other existing insolvency and restructuring procedures. The government acknowledges that write-down will not be appropriate in all circumstances, or for all insurers. As such, the perceived risk to bondholders in the event of insurer failure is likely to be smaller compared to in the bank resolution context.

8.51 Taking all of these factors into account, HM Treasury's upper estimate for the purpose of this additional analysis is a 29 basis point increase in insurers' debt issuance costs based on the UK findings in the BIS analysis referenced above. The total volume of unsecured debt issued by UK insurers is approximately £11bn.[132] This means that, using the 29 basis point UK debt issuance figure identified in the BIS data, the cost of debt funding could increase by £31.9m in a worst-case scenario (for the purpose of this additional analysis) spread across the population of UK insurers.

8.52 Were these costs to materialise, HM Treasury is confident that insurance firms have sufficient capacity to comfortably absorb the increase. The £31.9m figure representing the worst-case scenario compares, for instance, to dividend and interest payments by insurers of £8 billion in 2018.

8.53 However, as set out above, HM Treasury's central case assumption is that is that there will be no increase in insurers' debt issuance costs resulting from introduction of these measures. As a result, there is no EANDCB related to this potential cost for this measure. The table below summarises the estimated impact to the cost of debt issuance for insurers in both the central case assumption of 0 basis points and worst-case estimate of 29 basis points.

Table 8.B: Possible increase in annual funding costs if debt pricing (in basis points) were to increase

| **Increase in debt pricing (in basis points)** | **Increase in annual funding costs** |
|---|---|
| 0 (best estimate) | £0 |
| 29 (UK actual for bail-in proxy, 2016-2018) | £31.9m |

131 See The Bank of England's approach to resolution (the 'purple book') (https://www.bankofengland.co.uk/-/media/boe/files/news/2017/october/the-bank-of-england-approach-to-resolution)

132 Source: Prudential Regulation Authority data. This figure covers both basic own funds and instruments which are not included in own funds (as defined by the Solvency II Directive).

*Costs for Insurers: Reinsurance pricing*

8.54 Reinsurance is an arrangement in which an insurer transfers a portion of the risk associated with certain policies to another (re)insurer. If an insurer takes out reinsurance in relation to a particular policy, and then needs to pay a claim to the policyholder under that policy, the insurer that wrote the original policy (known as the 'cedant') is able to claim back a portion of its loss from the reinsurer.

8.55 Reinsurance agreements may have clauses which say that a reinsurer only has to pay out the amount the cedant insurer is able to pay to underlying policyholders (rather than the amount the cedant insurer is liable for – these amounts will differ where the cedant insurer is insolvent and unable to pay claims at 100% of their value). This kind of arrangement is known as 'pay-as-paid'.

8.56 'Pay-as-paid' clauses would be overridden by this measure, which would clarify that that any write-down of liabilities would not affect the amount a cedant insurer can claim under a reinsurance policy (i.e. reinsurers will remain liable for the full amount due, even if the court has reduced the value of the liability owed by the cedant insurer to the underlying policyholder).

8.57 The government has considered whether this clarification could affect the terms on which insurers are able to enter into reinsurance agreements, via a potential perception of increased exposure for reinsurers in the event of the cedant insurer's insolvency. However, under the current insolvency arrangements, a reinsurer's obligation to make payments to a cedant insurer is not diminished by the cedant insurer's insolvency (i.e. 'pay-as-paid' would not currently apply, and a reinsurer could not rely on a clause which made onward payment to the underlying policyholder a condition of payment to the cedant insurer). As such, the clarification set out under this proposal would not alter the status quo with regards to reinsurers' liabilities, and is therefore not expected to affect the pricing or terms of commercial reinsurance agreements.

*Costs for Insurers: Legal costs*

8.58 As with any insolvency or restructuring procedure, developing a proposal for a write-down and submitting this to the court is likely to incur legal (and administrative etc.) costs for the applicant (who is generally expected to be the insurer itself). As the write-down procedure under section 377 FSMA has never been used, there is no historic precedent on which to base an estimate of the legal costs associated with the proposed amended procedure. However, the government expects these costs to be broadly similar to those incurred in relation to schemes of arrangement. Schemes of arrangement typically involve establishing what proportion of its debts a firm can repay while remaining solvent, and in this regard may be similar to developing a write-down plan in terms of complexity and volume of work required.

8.59 Historic data is available on the legal costs associated with schemes of arrangement for insurers, with pertinent examples including BAI (Run-off) Limited, Black Sea and Baltic General Insurance Company Limited, and OIC Run-Off Limited. All of these insurers became insolvent and subsequently entered schemes of arrangement in the

late 1990s or early 2000s. Accounts filed with Companies House indicate legal costs of approximately £1m. Taking a £1m cost in the year 2000 as a representative figure, and applying GDP deflators gives a figure of £1.47m in 2019 prices. As such the government estimates legal costs associated with securing a write-down order to be £1.47m per case. Given the very large uncertainty regarding the frequency with which the amended write-down procedures will be used, there is no attempt to quantify ongoing or annual costs.

8.60 However, the cost is not expected to exceed the cost associated with insolvency or restructuring procedures likely to be used currently (which include schemes of arrangement). In particular, the legal costs associated with liquidation (the procedure to which section 377 FSMA currently provides an alternative) are typically higher than for schemes of arrangement. As such, the government assesses this cost to be nil relative to the counterfactual.

*Costs for Insurers: Cost of Notifying Affected Creditors*

8.61 Insurers subject to a write-down will be required to notify creditors affected by the write-down order, the PRA and the FCA once a write-down order has been made. Affected creditors will likely include both policyholders and other creditors.

8.62 Insurers may hold hundreds of thousands of individual policies, and so the costs of notifying policyholders of the write-down is likely to be significant. This cost is quantified below.

8.63 Notifying policyholders of these proposals coming into law would not incur an incremental cost, since notification could be made as part of regular communications. Here however, the cost of notifying affected policyholders of the write-down coming into effect in a particular instance will have to be made at shorter notice (rather than waiting for a regular round of communications), and potentially while the insurer is experiencing financial and/or operational disruption. As such, this cost should be quantified separately.

8.64 In 2017, the FCA surveyed firms on the cost of implementing measures to identify customers in persistent debt. The FCA calculated the average one-off costs of taking action in those circumstances, which included additional correspondence as well as setting up new systems and employing extra staff, at £0.37 per account (£0.39 in 2019 prices). Given that additional correspondence requirement represents only one part (and, arguably, the smallest part) of this calculated cost. The government assumes that the cost of notification to policyholders will be £0.10 per policy. Even this is expected to be a conservative estimate, for example should notifications by email be permissible, this could be done through pre-existing systems where these may already be used to notify policyholders.

8.65 The (mean) average life insurer in the UK has 1.1m active policies (although the distribution is skewed – the median number of policies is 80,000). The (mean) average non-life insurer in the UK has 80,000 active policies.

8.66 Using the estimated notification costs of £0.10 per policy implies that the notification costs for a life and non-life insurer undergoing a write-down would be, on average, £110,000 and £8,000 respectively. However, these costs would only arise in the event of an insurer failure and, given the rarity of insurer failures in the UK, HM Treasury has not attempted an annual estimate for this cost.

8.67 Given insurers should be in regular contact with their wider creditors, notifying these creditors should not create significant additional expense.

8.68 Costs associated with notifying the PRA and FCA are expected to be negligible given the existing channels of communication between insurers and the financial regulators.

8.69 These notification costs are indirect costs of these proposals, since they will not be incurred unless and until the write-down comes into effect. As such they have not been included in the EANDCB figure.

Costs associated with enabling the court to appoint a write-down manager to support a write-down under the amended section 377 FSMA

*Applying for a write-down manager's appointment*

8.70 In order for the court to appoint a write-down manager, the applicant will need to prepare an application detailing the candidate's experience and suitability for the role. This application will be considered by the PRA, which will need to vet the candidate write-down manager to confirm that they are suitably qualified and free of conflicts of interest before consenting to the application for their appointment being put to the court.

8.71 The PRA is likely to charge a fee for this process. While this fee will be set at a later stage, the PRA has estimated (using fees for transfer for of insurance business under Part VII FSMA as a comparison) this fee at £18,500 for life insurance business, or £10,000 for general insurance business. The PRA may also choose to charge a 'special project fee', of £50,000, if a threshold for chargeable hours of work is met133. As such, the estimated cost to a potential applicant of applying for a write-down manager's appointment is in the range £10,000 – £50,000. However, given the difficulties associated with estimating the frequency with which write-down managers will be appointed, this analysis does not attempt to translate this into a monetised ongoing cost to business. Any resourcing costs associated with the PRA undertaking this function are expected to be either absorbed into existing resource or recovered through fees it may charge.

8.72 The FCA may also need to consider charging a specific fee or 'special project fee' in the event of a write-down (or indeed whether this would be covered by the general regulatory fees paid by insurers). Under FCA rules, a 'special project fee' is only payable if the amount calculated for regulatory work is £25,000 or £50,000

[133] This fee, if charged, is expected to cover PRA consideration of both the proposed write-down manager, and write-down application. Since consideration of a candidate write-down manager will usually come first, this cost is considered here rather than under the costs of a write-down application.

depending on whether the firm is solo or dual-regulated. This is a threshold for charging the fee, rather than a cap. Given this uncertainty, and the rationale outlined in the paragraph above, HM Treasury does not attempt to translate this into a monetised ongoing cost to business.

*Write-down manager's remuneration and costs*

8.73 All insolvency and restructuring procedures will incur some degree of legal and administrative costs, and require the remuneration of IPs and/or other professionals. Given the complexity of insurance undertakings, and the typically long duration of insolvency procedures[134], these costs can be significant. As an illustrative example, East West Insurance Company Ltd ('East West') entered administration on 12 October 2020[135]. The joint administrators have estimated their remuneration at approximately £5m, and other expenses (e.g., for legal and consultancy fees, claims handling providers) at approximately £10m[136]. East West has a comparatively large number of policies for a general insurer[137], increasing the complexity and cost of insolvency proceedings. However, these costs are still significantly lower than they might be for a life insurer failure.

8.74 Given that a write-down manager may remain in post for years or decades while an insurer's remaining policies are run off, it may be expected that a write-down will incur higher associated costs than other procedures. However, office-holders being in post for long periods is already the norm when insurer issuing long-term policies fail. As an example, BAI (Run-off) Ltd entered provisional liquidation in 1998, before a scheme of arrangement came into effect in 2002.[138] The scheme administrators (partners at PWC) are still in post, and invoiced BAI £1.2m in fees in 2020.[139]

8.75 While a write-down manager may be in post for longer than office-holders under other procedures, their annual costs will typically be lower. Unlike administration for example, a write-down retains an insurer's directors and management, and should have little effect on its operations or contractual arrangements. As such the workload for a write-down manager and their staff should be lower than that for office-holders under other procedures. Once an insurer is in run-off following a

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[134] The base period for insurer administration is 30 months, compared to the standard corporate administration period of 12 months.

[135] Source: FSCS (https://www.fscs.org.uk/making-a-claim/failed-firms/east-west/).

[136] Joint Administrators' fee estimate and details of expenses (https://assets.ey.com/content/dam/ey-sites/ey-com/en_uk/generic/east-west-insurance/ey-joint-administrators-fee-estimate-and-details-of-expenses.pdf).

[137] In 2018 East West acquired 387,000 buildings guarantee policies. The Bank of England estimates that there are 72.8m general insurance policies in force in the UK. Dividing these by the 450 general or composite insurers in the UK (Bank of England / PRA data) gives a (mean) average of 160,000 policies per non-life insurer.

[138] Source: PwC (https://www.pwc.co.uk/services/business-restructuring/insights/brs-uk-ins-assignment-bai-run-off-limited-in-scheme-of-arrangement.html)

[139] BAI (Run-off) Ltd Annual report and financial statements 2020 (https://find-and-update.company-information.service.gov.uk/company/00015228/filing-history?page=1).

write-down, the write-down manager's role is primarily one of oversight, and is unlikely to involve engagement in the insurer's day-to-day affairs.

8.76 On balance therefore the government expects that the costs and remuneration required under a write-down will be similar to those under alternative procedures and should represent nil additional cost relative to the counterfactual. Given that no data exists on the remuneration of write-down managers, any attempt at quantitative analysis would be speculative.

Costs associated with ensuring that the FSCS is able to appropriately protect eligible policyholders following a write-down

*Costs for the FSCS[140]: Funding Costs*

8.77 Under this measure, the PRA's powers to set rules for the operation of the FSCS will be altered. The PRA will then set rules allowing the FSCS to make 'top-up payments' to policyholders whose claims are reduced via a write-down[141]; and in the event of an insurer defaulting following a write-down, compensate policyholders based on the original, pre-write-down value of their claim, rather than the lower, written-down value.

8.78 The most appropriate counterfactual to compare against is not the use of section 377 FSMA currently (given that the write-down power has never been used, and is unlikely to be used without amendments to increase its usability), but insurer insolvency absent the use of section 377 FSMA. Currently, when an insurer fails, the FSCS can protect eligible policyholders by paying (90% or 100% of)[142] any crystallised policyholder claims. The cost of this type of compensation will be the same either following a write-down under the revised write-down power, or following the insurer entering insolvency (the most likely counterfactual absent a write-down). As such, these proposals will not affect FSCS costs associated with this type of compensation.

8.79 For policyholders whose claims have not crystallised, the FSCS can:

140 Note that the FSCS is funded by a levy on the financial services sector, so any FSCS costs are ultimately passed through to wider industry.

141 While there may be a resource cost for the PRA associated with updating its Rules, as the PRA is operationally independent, it is not possible for the government to prejudge the complexity of any changes and so this cannot be estimated. However, the government anticipates any cost will be absorbed within existing budgets.

142 FSCS compensation limits for eligible insurance policyholders are 100% for long-term and life insurance, and some types of compulsory general insurance (e.g. third-party motor), and 90% for other general insurance policies.

a. Provide financial assistance, either to the insurer in question, to facilitate the transfer of policies to a viable insurer, or to secure the issue of replacement policies[143];

b. If there is no suitable insurer to replace the failed insurance firm's policies, the FSCS can refund the remaining portion of insurance policy premiums.

8.80 To assess the cost impact of these proposals, it is necessary to consider whether each of the above options would present higher or lower costs than the FSCS would incur following a write-down.

8.81 Refunding policy premiums may be the cheapest option; however this is not the FSCS's preferred option, as it does the least to preserve continuity of cover for policyholders. The FSCS has significant scope to secure continuity of cover for policyholders and (in relation to long-term (life) insurance business) can take measures to do so even where this exceeds the cost of paying compensation.[144] As such, the FSCS is unlikely to choose to refund premiums following a life insurer failure (the circumstances in which the government anticipates a write-down is most likely to be sanctioned). Therefore, the most relevant comparison is between the costs to the FSCS following a write-down, and the cost of providing financial assistance.

8.82 The cost to the FSCS of providing financial assistance is expected to be very similar to the costs associated with a write-down. In each case the FSCS is providing the level of funding required to enable an insurer to meet its obligations to policyholders, either by increasing its assets (through financial assistance) or funding a reduction in its liabilities (through a write-down).

8.83 Furthermore, there are two mechanisms which should reduce FSCS costs in the event of a write-down, compared to insolvency under the current arrangements. First, the intention of a write-down is to avoid the value-destruction and costs associated with insolvency, thereby maximising the resources available for distribution to creditors (and the court will only sanction a write-down where it is reasonably likely to lead to a better outcome for creditors, compared to the most likely alternative). As such, the 'gap' between an insurer's assets and its obligations to policyholders, and therefore the level of funding the FSCS is required to provide (either directly via financial assistance, or indirectly via 'top-up payments'), should be smaller following a write-down than in the event of insolvency.

8.84 Second, under these proposals the FSCS will be able to pursue recoveries against the insurer for 'top-up' payments. The FSCS cannot currently pursue recoveries following the provision of financial assistance to an insurer (as it does not take over the claims of any particular policyholders). Therefore, should an insurer's financial position

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143 The FSCS's broad powers to provide assistance to an insurer in financial difficulties is set out in the Policyholder Protection part of the PRA Rulebook (https://www.prarulebook.co.uk/rulebook/Content/Part/213382/07-10-2021).

144 See Section 4.1(3) of the Policyholder Protection part of the PRA Rulebook (https://www.prarulebook.co.uk/rulebook/Content/Chapter/213386/07-10-2021).

subsequently improve, and additional funds become available for distribution, the FSCS will be in a better position to recover some of its costs following a write-down.

8.85 Taking into account the costs the FSCS is currently likely to incur when an insurer enters financial difficulties, and the two mechanisms detailed above, it is expected that FSCS funding costs will not significantly differ in the event of a write-down. A reduction in FSCS funding costs is more plausible than an increase (given reduced value destruction and the possibility of recoveries); however, to present a conservative estimate this analysis treats this cost as nil relative to the counterfactual.

8.86 Given the number of assumptions required, and the lack of data available in relation to write-downs under section 377 FSMA, any quantitative analysis of FSCS funding costs under different insurer failure scenarios is unlikely to be meaningful.

Costs associated with introducing a temporary moratorium on early termination clauses found in supply and financial contracts held with insurers

*Costs for insurers: Financial contract pricing*

8.87 Insurers will hold a variety of financial contracts. The proposed moratorium will limit the ability of firms to terminate financial contracts held with insurers on the grounds of that insurer's insolvency or restructuring. These firms may see this change as increasing their credit risk (i.e. the risk that the insurer does not the full amount it owes under any contract) since they will have to continue dealing with a potentially insolvent insurer for longer. If firms do see the moratorium as increasing their credit risk, they may compensate by demanding higher prices when entering into contracts with insurers. This would increase insurers' operational costs, representing a direct cost to business.

8.88 HM Treasury does not expect that the proposed moratorium would increase (real or perceived) credit risk faced by insurers' counterparties, given that:

a. The moratorium includes a safeguard[145] ensuring that it does not affect set-off or netting arrangements[146] in financial contracts, which represent an important risk management practice.

b. The moratorium will not prevent termination if the insurer fails to make timely payment (or meet any other contractual obligation).

c. Counterparties will be able to apply to the court for an exemption from the effect of the moratorium, which will be granted if the court believes that the moratorium could cause the counterparty financial hardship.

145 This safeguard will be based on the concept of 'protected arrangements' created under Section 48P of the Banking Act 2009.

146 These are arrangements to combine multiple offsetting financial obligations between two parties into a single net figure. This reduces the risk associated with a counterparty's insolvency, by ensuring that any sums owed by the insolvent counterparty can be deducted from the amount owed to that same counterparty.

8.89 As such, HM Treasury has assumed the cost to counterparties (and therefore any cost passed through to insurers) as a result of the proposed moratorium to be nil, in line with past experience.

*Costs for insurers: Supply contract pricing*

8.90 Similar concerns about credit risk could arise for suppliers of goods or services (for example, firms supplying buildings management services to an insurer) as a result of the proposed moratorium. Again, a perceived increase in credit risk could lead to insurers facing higher costs when negotiating supply contracts.

8.91 The impact assessment published for CIGA[147], which introduced a similar restriction on the use of early termination clauses, estimated the cost to suppliers on the basis that some proportion would take out trade credit insurance to manage a perceived increase in credit risk. Trade credit insurance typically costs between 0.15% and 0.3% of a company's turnover, representing a small but non-negligible cost.

8.92 However, as with financial contract pricing, considered above, there are compelling reasons to expect that any (perceived or real) increase in credit risk for insurers' suppliers will be minimal. Ongoing payments due to suppliers will have to be met (since the proposed moratorium only prevents termination by reason of the write-down process). Given that suppliers will typically be paid regularly, the quantum of any outstanding arrears during the period of the moratorium's application is likely to be low. For example, a service provider which is normally paid on a monthly basis will be exposed to, at maximum, one month's worth of arrears if an insurer were to default during the moratorium's application. This exposure is no higher than the exposure should an insurer default currently, given that the proposed moratorium would not allow the insurer to accrue greater arrears. As such, the moratorium should not increase a supplier's loss in the event of counterparty default. HM Treasury has therefore treated the increased costs to suppliers (and therefore any cost passed on to insurers through higher contract pricing) as nil.

*Costs for wider industry: Applying for hardship exemptions*

8.93 Suppliers and financial contract counterparties will both have access to a mechanism to apply to the court for an exemption from the effect of the proposed moratorium, if it were to cause them financial difficulty. As set out above, the moratorium is not expected to increase supplier or counterparty credit risk, and so should not create financial hardship for affected parties. However, it is plausible that if a supplier or counterparty were experiencing unrelated financial distress, they may wish to terminate certain commercial relationships, including any with insurers, and the moratorium may prevent this. In these circumstances, the supplier or counterparty may need to apply to the court (or certain other parties), citing hardship, in order to be exempted from the effect of the moratorium. Any associated costs will be indirect costs of these proposals.

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147 https://publications.parliament.uk/pa/bills/cbill/58-01/0146/SIGNED%20-%20IA%20Insolvency%20and%20Corporate%20Governance%20Enactment%20Stage.pdf

8.94 The Insolvency Service has previously estimated that the legal costs of insolvency court challenge procedures to be around £4,000 per case. The cost of applying for a hardship exemption under these proposals is expected to be comparable. As detailed above, and as a conservative estimate, the government assumes that a representative insurer has 10-20 suppliers.

8.95 As a proxy for the prevalence of firms experiencing financial hardship, the government has taken the most recent surveyed annual rate of company liquidations of 0.33%[148], and tripled this to give a "hardship rate" of approximately 1% (reflecting that the majority of firms experiencing some form of financial distress will not go on to enter liquidation).

8.96 Multiplying the historical insurer insolvency rate of 0.5 per year by the proposed "hardship rate" of 1% demonstrates that a supplier in financial difficulty will need to make use of the hardship exemption approximately only once every 10 years. As such, the estimated costs derived from this analysis will be significantly smaller than the associated uncertainties, and the government will not further quantify this negligible cost.

8.97 Data regarding the number of financial contract counterparties an insurer is likely to have is less readily available than data on supplier relationships. However, given the low rate of insurer insolvency, the low rate of general corporate financial distress, and the relatively low estimated cost of making a hardship application, it is unlikely that this cost will be large enough to provide any meaningful estimate. HM Treasury has therefore not quantified this cost.

Costs associated with introducing a temporary stay on surrender clauses contained in certain life insurance policies

*Costs for policyholders: Applying for Hardship Exemptions*

8.98 In the event that the proposed stay comes into effect for a given life insurer, a proportion of policyholders may need to apply to the court (or certain other parties) for exemptions on the basis of financial hardship. Any associated costs would be indirect costs of these proposals.

8.99 Such applications are expected to be rare given that the stay will depend upon the insurer continuing to make any scheduled payments that may be due under policies. Furthermore, policyholders whose policies are already in draw-down (i.e., policyholders who derive regular income from withdrawals from their life insurance policies) will not be prevented from continuing to withdraw funds. As such, policyholders who do not change their behaviour once the stay comes into effect may never notice any effects of the stay (which is primarily intended to prevent surrenders motivated by concern regarding an insurer's solvency, akin to a 'run' on a bank).

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[148] Source: Company Insolvency Statistics, October to December 2021. From the Insolvency Service and available on the government website here: https://www.gov.uk/government/statistics/company-insolvency-statistics-october-to-december-2021.

8.100 Nevertheless, some proportion of policyholders may experience life events, such as bereavement, illness, or financial loss, which create a need to access the value of their policy on an extraordinary basis. These policyholders will be able to apply to the write-down manager or certain other parties; this type of application should not incur notable costs. However, where this application is refused, the policyholder will be able to apply to the court.

8.101 This type of court application is expected to be significantly less onerous than applications from firms for exemptions from the proposed moratorium (set out above). The government expects that specialist legal representation will not be required. The only significant cost is likely to be from court fees. While no court fee has yet been set for this type of application, which does not exist under the current arrangements, the 'any other petition' fee of £280 in insolvency proceedings set out in section 3.3 of Schedule 1 to the Civil Proceedings Fees Order 2008 provides an estimate.

8.102 No data is available from which to estimate what proportion of affected policyholders who will experience financial hardship during the period the stay, which will apply for 6 months by default in the case of a write-down, or 30 months by default in the case of administration (though can be extended or concluded early by court order in both cases). Given this, the government will not further quantify the total cost associated with making hardship exemption applications (although the figures above provide a useful estimate of the likely costs in an individual case).

Total direct quantified costs contributing to EANDCB

8.103 **As noted above, the only direct costs to business are familiarisation and debt issuance. The familiarisation costs will be £0.95-£2.66 million, with a best estimate of £1.80 million. The costs of debt issuance are £0-£31.9 million, with a best estimate of £0. Over a ten-year appraisal period this gives an EANDCB of £0.2 million for this measure.**

**Policy Benefits**

8.104 The benefits are the same across all the areas of the insurer insolvency measure in the Bill.

*Reduced losses and value destruction*

8.105 When an insurer enters financial difficulties, various factors may reduce the pool of assets available for distribution, significantly impacting the outcome for policyholders and other creditors. This reduction in the value of assets is termed 'value destruction.' As a package, these proposals aim to mitigate the risk of value destruction, in several areas outlined below:

a. The proposed amended write-down procedure provides a direct route to restructure an insurer's liabilities while retaining the insurer's management,

staff, operational structure and systems. As such disruption to the insurer's business operations, which could lead to further financial deterioration, may be almost entirely avoided. This is preferable to liquidation, where assets may have to be sold off at a loss and profitable business lines are permanently abandoned.

b. Furthermore, the proposed write-down power will give struggling insurers and the PRA the power to apply for a write-down at an earlier point than is currently possible, while the insurer's financial position is still relatively robust and it has not suffered a significant decline in confidence or loss of willing suppliers or contractual counterparties. As such, the availability of an amended write-down tool is expected to reduce losses at the point of insolvency, to the benefit of insurance policyholders, other creditors, and ultimately the wider financial services sector through reduced need for FSCS compensation.

c. The proposed moratorium on contractual termination rights will mitigate the risk that insurers' financial contract counterparties choose to terminate their contracts when an insurer enters insolvency or write-down procedures. This proposal should reduce sudden exposure to financial risk which could lead to further deterioration in an insurer's financial position.

a. The proposed moratorium will also mitigate a parallel risk arising from termination of supply contracts. The termination of supply contracts could undermine an insurer's ability to continue operating, ultimately pushing it into insolvency with the associated costs and loss of value.

8.106 All of these mechanisms lead HM Treasury to assess that the proposed amendments will lead to preferable outcomes for policyholders, creditors and wider industry in the event of insurer failure.

8.107 It is not considered proportionate to attempt to quantify this benefit given that the costs and loss of value associated with any insurer failure will be highly fact-specific, and depend on the insurer's size, area of specialisation and business model, wider economic conditions, and the circumstances which led the insurer to experience financial difficulties.

8.108 While this expected benefit cannot be quantified, the scale of potential value destruction in the life insurance space can be illustrated using evidence from the case of Equitable Life. Equitable Life, a UK life insurer, was forced to close to new business in December 2000 after experiencing financial difficulties and entered a scheme of arrangement in September 2001. Equitable Life's creditors suffered (absolute[149]) losses of between £2.9bn and £3.7bn[150]. Shortly before the scheme of arrangement was agreed, in August 2001, Equitable Life had assets of

[149] Note that the relative losses (the difference between the actual returns received from Equitable Life and the assumed returns that the policyholder would have received if they had invested the same amount in a similar product in a comparable company) were estimated to be higher, at £4bn - £4.8bn.

[150] Source: BBC (https://www.bbc.co.uk/news/mobile/business-10725923).

approximately £29bn and liabilities of approximately £30bn, giving a net balance sheet deficit of approximately £1bn. Taking the midpoint of the estimated loss range at £3.3bn implies losses of approximately £2.1bn over and above the balance sheet deficit. As such it is reasonable to estimate costs and value destruction during Equitable Life's restructuring of approximately £2.1bn, or approximately 7.2% of the value of assets.

8.109 While these figures are highly specific to the case of Equitable Life, and not generalisable, they illustrate the potential impact of value destruction for insurers. As set out above, HM Treasury expects that these proposals may reduce the scale of value destruction for insurers in financial difficulties but will not attempt to quantify this reduction.

*Improved continuity of cover*

8.110 These measures will improve the prospects of securing continuity of cover (i.e. continuous, uninterrupted insurance cover for policyholders) when an insurer enters financial difficulties.

8.111 Currently, continuity of cover for policyholders of insurers in financial difficulties may be uncertain where the insurer enters certain insolvency procedures.[151] Policyholders who lose insurance cover may find it impossible to secure replacement policies on the same terms or at the same price. Loss of cover can be extremely detrimental both to retail policyholders (i.e., where a household loses home or motor insurance) and to businesses (i.e., where a business becomes unable to trade after losing liability insurance coverage).

8.112 The write-down power, once amended in the Bill, will provide a procedure which ensures continuity of cover for policyholders by avoiding insolvency. While this coverage will be paid at a reduced level, FSCS 'top-up payments' will be available for all protected policyholders. Those protected policyholders covered to 100% of the value of their claim, including all life insurance policyholders, should not experience any changes to the operation of their policies following a write-down. This policy change is especially beneficial for life insurance policyholders as they are most likely to be severely affected by loss of cover given that (1) life insurance policies may represent a source of income; and (2) life insurance policyholders may be unable to find replacement policies on the same terms if their circumstances (for example, their life expectancy) has changed since the original policy was purchased.

8.113 The proposed moratorium on contractual termination rights, and proposed stay on life insurance policy surrender rights, will also indirectly promote continuity of cover, by increasing the likelihood that an insurer in financial difficulties can avoid insolvency and continue to administer claims.

*Enhanced confidence*

[151] While many types of insurance are protected by the FSCS, only life insurance (and some compulsory general insurance) policies are protected to 100% of the value of the claim. In addition, the FSCS may protect eligible policyholders by refunding the outstanding portion of premiums following an insurer failure, rather than by providing replacement contracts, leading to a loss of cover.

8.114 HM Treasury anticipates that these proposals will enhance confidence in the UK's insurance sector and financial regulation, both by making the UK's insolvency arrangements more robust and more closely aligned with international standards and best practice. The proposals are also expected to reduce the risk of disorderly insurer failure, an event which could significantly negatively affect market confidence.

8.115 Increased confidence may lead to greater investment in the UK's insurance sector, facilitating growth and potentially reducing financing costs for UK insurers. HM Treasury will not attempt to quantify this benefit, given the difficulties in measuring confidence or predicting how far these proposals will alter perceptions of the UK's insurance sector or regulatory framework.

**Assumptions, limitations, and considerations**

8.116 As outlined in the 'methodology' section above, the assumptions used in this analysis have been tested with industry stakeholders and affected groups (via a formal consultation) who broadly agreed with the government that the Bill could provide significant benefits to insurers, their creditors, and policyholders, in certain scenarios.

8.117 Additionally, one limitation across the costs and benefits discussed in this chapter is the difficulty in estimating how frequently the (amended) write-down power will be used following the introduction of this measure. As the procedure has never been used in the past, and given that insurer failure itself is rare (only 11 UK-regulated insurers have defaulted since 2000), there is no existing base rate from which to estimate. HM Treasury could have chosen to assume that some proportion of insolvent insurers will in future use the write-down procedure. However this would be largely speculative and potentially misleading. Instead, HM Treasury has in various places estimated costs (for example, application costs) on a 'per use of the write-down power' basis, without trying to translate this into a quantified annual cost, which would be unreliable.

**Small and MicroBusiness Assessment (SaMBA)**

Number and distribution of businesses in scope of the regulation

8.118 These proposals apply primarily to insurers operating in the UK. The government does not hold data, and is not aware of data sources, which would indicate the distribution of these insurers in the UK by number of employees.

8.119 However, analysis undertaken by the PRA suggests that of 364 UK authorised insurers[152], 164 of these firms had total gross written premiums[153] of under £10.2 million, and so could reasonably be classed as small and micro-insurers. This suggests that c.45% of insurers operating in the UK could be considered to be small and micro-insurers.

8.120 As set out above, there are currently 595 authorised insurers in the UK154 relevant to this measure, this would suggest there are c.268 firms which could reasonably be considered to be small or micro insurance businesses.

Do the impacts fall disproportionately on small and microbusinesses?

8.121 These proposals are not expected to have disproportionate benefits or costs on any small or micro insurance businesses. It will only directly affect insurance businesses that are in financial difficulties. For historic failures where data is available, Bank analysis shows that most firms have assets at the point of default of £40 million or more (with one having assets of £1.7 billion). Extrapolating from this partial data set, this historic data on insurer failures supports an expectation that this measure will not disproportionately affect small and micro firms (when other, risk-based factors are taken into account).

8.122 As well as applying to insurers, this measure will have consequences for firms which deal with insurers who are in financial difficulty, through either financial or supplier relationships. Firms holding financial contracts with insurers are very unlikely to be small or micro businesses; however, firms supplying goods or services could be smaller businesses (although the government does not hold and is not aware of data on the size of suppliers to the insurance industry, and it would be disproportionate to seek to gather this data, given the minimal expected costs for suppliers).

8.123 Small suppliers could be more severely affected by the proposed moratorium on contractual termination rights, given that the affected contract would be a larger part of the supplier's overall business. The proposed moratorium already includes robust safeguards to protect suppliers from financial harm. These include the fact that the moratorium will fall away if an insurer fails to make payments on time, and the proposed hardship exemption process which will allow suppliers to seek an exemption from the court. This means that were any small or microbusinesses

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[152] This includes PRA-regulated Solvency II firms as of the 2022 financial year and PRA-regulated insurers and friendly societies which fall below the threshold for Solvency II reporting. To note, friendly societies are excluded from the scope of the planned amendments as they do not fall within the definition of 'insurer' provided for by the Financial Services and Markets Act 2000 (Insolvency) (Definition of Insurer) Order 2001 (SI 2001/2634). However, they have been included within this analysis as a matter of necessity. This figure also includes an unidentified discrepancy of 4 firms.

[153] The government considers that gross-written premiums – i.e. the total revenue from a contract expected to be received by an insurer before deductions for reinsurance or ceding commissions – (while a measure of new insurance business) are an appropriate substitution for turnover in this context.

[154] Source: Bank of England / PRA. As set out earlier in the document, this figure also includes all UK-authorised insurers, Gibraltar-authorised insurers, and insurers incorporated in the European Economic Area (EEA) with deemed Part 4A permission in the Temporary Permissions Regime (TPR) or Supervision Run-Off (SRO) which are not included in the 364 figure listed above. For these firms, the PRA does not collect data on gross written premiums and so comparable analysis is not possible.

exposed to disproportionate impacts of the moratorium to the extent it will cause hardship for the business, they will have the option to apply to the court for an exemption. The court will then determine if restricting the early termination of a contract has caused hardship to any person. If so, an exemption from the moratorium will be provided. However, as set out above, the government does not expect the proposed moratorium to increase the expected costs for suppliers compared with the insolvency counterfactual, and this analysis applies equally to suppliers which are small or micro business.

8.124 Finally, given that the costs and loss of value associated with any insurer failure will be highly fact-specific, it is not possible to tell whether the failure of any given insurer will have disproportionate impacts on small and microbusinesses that supply it. Impacts here will largely depend on the insurer's size, area of specialisation and business model, wider economic conditions, and the circumstances which led the insurer to experience financial difficulties. The specificities noted here mean it is not possible to judge, prima facie, whether there will be disproportionate impacts.

Could small and microbusinesses be exempted while achieving the policy objectives?

8.125 The government has considered exempting small or micro insurance businesses from these provisions. However, these proposals are designed to provide additional protections and greater flexibility for insurers in financial difficulties; as such, excluding smaller firms and/or microbusinesses would create a disproportionate disadvantage for these firms, and potentially lead to higher costs at the point of insolvency for these firms.

8.126 The government has also considered exempting small or micro businesses which supply insurers from these provisions. However, as these proposals seek to provide additional protections and greater flexibility for firms judged to be in financial difficulties, excluding these firms from the moratorium, or differentiating their terms, in an attempt to mitigate the impacts of the moratorium on these firms would create a disproportionate disadvantage for these firms, and potentially lead to higher costs at the point of insolvency for an ailing insurer. This latter possibility would contravene the logic of the write-down and moratorium, which is to stabilise an insurer.

Could the impact on small and microbusinesses be mitigated while achieving the policy objectives?

8.127 The government has considered whether impacts on small and microbusinesses could be mitigated while achieving the policy objective. The government has concluded that, mirroring the points made above, mitigating impacts on smaller and microbusinesses could only involve exempting these firms, which would undermine the policy objectives.

Wider impacts on small and microbusinesses

8.128 Small and micro businesses may also be policyholders of an insurer, and their policy benefits may therefore be written-down by order of court under these measures. The court can only order a write-down if satisfied that this is reasonably likely to lead to a better outcome for the insurer's policyholders and other creditors (taken as a

whole) than not making the order (i.e. comparing a possible write-down with the next most likely counterfactual e.g., insolvency procedures). Thus, whilst the write-down itself imposes losses on policyholders, it is designed to produce a better outcome than they would face if the insurer were to become insolvent. Small businesses are eligible claimants under the FSCS (subject to the usual FSCS eligibility criteria and applicable limits), and would therefore generally be entitled to top-up payments in respect of written-down amounts. For this purpose, a small business is defined in PRA rules as "a partnership, body corporate, unincorporated association or mutual association with an annual turnover of less than £1 million (or its equivalent in any other currency at the relevant time)." Given the court test (which ensures a write-down is reasonably likely to lead to a better outcome overall, compared with the counterfactual), and the availability of FSCS cover for small businesses, the government is satisfied this will help ensure that that the measures do not disproportionately impact small and micro businesses who are policyholders.

8.129 However, it is not possible to provide a precise estimate of the size of the population of small and microbusiness who are insurance policyholders. Providing a precise estimate would involve collecting data in relation to the number of employees and turnover for all parties who may be able to claim under all contracts of insurance written by a firm. HM Treasury does not consider it proportionate to attempt to obtain this data, as it understands that insurance firms themselves would not hold this type of data.

8.130 HM Treasury has not identified any other areas in which these measures could disproportionately impact on small or micro businesses.

## Recognised Bodies: Senior Managers and Certification Regime

**Problem under consideration**

9.1 As set out in previous chapters, CCPs (central counterparties), CSDs (central security depositories), RIEs (recognised investment exchanges) and CRAs (credit rating agencies) are types of financial market infrastructures (FMIs). FMIs are institutions that underpin the UK's economic and financial systems. A well-functioning system of FMIs creates stability in the financial services sector and provides critically important functions that help make markets safer and more efficient. The corollary of their significance is that the failure of an FMI could threaten the financial stability of the UK or cause significant disruption to the wider UK economy and to consumers.

9.2 Since the global financial crisis, significant progress has been made towards ensuring that the FMIs that underpin the UK's economy and financial system are robust and well regulated. Existing domestic regimes, combined with new international standards implemented through EU legislation (now part of retained EU law), have given the Bank of England (Bank) and the FCA many of the tools to effectively supervise these entities and impose penalties on firms as a whole if they breach legislative requirements.

9.3 Following the global financial crisis, it also became clear that a new legislative and regulatory framework was necessary to ensure senior management within the financial services sector could be held to account for significant business and conduct failures that occurred on their watch. In response, Parliament introduced the Senior Managers and Certification Regime (SM&CR) for banks and insurers, which was launched in 2016. Central to this was a requirement that the most senior decision-makers in firms should have clearly assigned responsibilities and be accountable for actions within their remit.

9.4 Whilst the current SM&CR applies to individuals within firms authorised to perform regulated financial services under FSMA, the existing regulatory regimes for FMIs make very limited provision for the oversight of individual conduct, with most supervisory and enforcement powers focussed on the legal entity. Through the introduction of an SM&CR for FMIs, the government intends to address this deficiency, and ensure that individuals who hold positions of influence within FMIs have suitable skills and experience.

**Rationale for intervention**

9.5 Since the financial crisis, given their importance to the stability of the financial services system, FMIs have been subject to greater levels of regulation. This regulation has contributed to ensuring that CCPs, CSDs, CRAs and RIEs have been subject to high standards spanning all areas of risk, and that governance of these firms conforms to requirements set out in legislation.

9.6 However, the existing regulatory regimes make very limited provision for oversight of individual conduct within these entities as most supervisory and enforcement powers are focussed on the legal entity (i.e. the FMI itself). The introduction of an SM&CR would provide for greater regulatory oversight of individual conduct. The

proposed regime would strengthen the individual accountability of senior managers within FMIs and would provide an effective and proportionate means for ensuring high standards of conduct amongst all staff. This would ensure that the firms which underpin the proper functioning and overall stability of the UK's financial system are subject to the highest regulatory standards.

9.7 This Bill closely follows the existing SM&CR that is applied to many firms regulated by the PRA and FCA. The SM&CR was introduced to improve conduct and behaviour in the financial services industry, and has been applied across banks, building societies and credit unions since 2016. It was extended to insurers in 2018 and all other FCA solo-regulated firms in 2019.

9.8 It has not, to date, been extended to CCPs, CSDs, CRAs and RIEs. Employee misconduct or an unclear allocation of responsibilities at these systemically important firms could lead to operational, or other types, of issues. Given the fundamental importance of these firms to the UK's financial services ecosystem, these issues could in turn lead to problems elsewhere in the financial system. A PRA evaluation[155] on SM&CR published in December 2020 highlighted that the introduction of the regime has helped ensure higher professional standards amongst senior management in banks and insurers, clearer lines of responsibility and accountability within firms, as well as positive changes in standards of conduct. Given that CCPs and CSDs are highly systemic institutions, the same high conducts standards that exist for PRA- and FCA- regulated firms should be extended to Bank-regulated CCPs and CSDs.

9.9 Employee misconduct or an unclear allocation of responsibilities at these systemically important firms could lead to operational, or other types, of issues. Given the fundamental importance of these firms to the UK's financial services ecosystem, these issues could in turn lead to problems elsewhere in the financial system.

9.10 As set out in the FCA's 2020/2021 Perimeter Report[156], extending the SM&CR to FCA-regulated RIEs and CRAs could deliver greater accountability and robust oversight of functions that promote market integrity. A number of key trading venues are part of the same group as CCPs. As such, extending the SM&CR to RIEs could ensure that consistently high standards are maintained across the whole group. HM Treasury is considering this recommendation, and will make a decision on whether the SM&CR should be extended to these entities in due course, following consultation.

**Policy Objective**

9.11 Applying the SM&CR to CCPs and CSDs, and to RIEs and/or CRAs, should the government decide to do so in the future, would give the regulators a robust supervisory toolkit to ensure that senior managers have clear responsibilities, with

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[155] https://www.bankofengland.co.uk/prudential-regulation/publication/2020/evaluation-of-the-senior-managers-and-certification-regime

[156] https://www.fca.org.uk/publication/annual-reports/perimeter-report-2020-21.pdf

clear accountability for addressing risks and resolving supervisory priorities. It would also provide an effective and proportionate means for ensuring high standards of conduct amongst all staff. Finally, it will provide enforcement powers for the relevant regulator to take action where appropriate.

**Description of Options Considered**

9.12 Option 0 (Do nothing) - under this option HM Treasury would not have the necessary powers to ensure that it can, where it judges it to be appropriate, give the Bank and the FCA powers to oversee individual conduct within these systemically important firms.

9.13 Option 1 (Preferred Option) - legislate to create an "SM&CR gateway", granting HM Treasury the ability to provide the Bank and the FCA with powers to strengthen governance and regulate individual conduct within FMIs, where it judges this to be appropriate. Applying the SM&CR to FMIs would bring their governance arrangements in line with most other types of firms within the financial services sector.

**Outline of preferred policy**

9.14 The key features of the proposed regime will be similar to the existing SM&CR for banks, insurers and other authorised persons as set out in Part 5 of FSMA. The relevant regulator would be responsible for application of the regime in respect of the entities which they regulate, and will be granted new powers to implement, supervise and enforce the following:

a. A Senior Managers Regime. This regime gives the regulators power to determine whether those entering certain management positions in these entities have the appropriate competence, expertise, and probity to carry out their roles. It also requires firms to clearly document the scope of senior managers' responsibilities and ensures that senior managers take reasonable steps to prevent and/or stop regulatory breaches within areas of their responsibility.

b. A Certification Regime. Under this regime, firms are required to certify as fit and proper any individual performing a role that could cause significant harm to the firm or its users, both on recruitment and annually thereafter.

c. Conduct rules for all employees. These set a minimum standard of conduct for individuals for a broader range of employees within a firm.

9.15 HM Treasury, following consultation in 2021, intends to create an SM&CR for CCPs and CSDs. As such, there are four firms that will be affected by these changes. These are: three CCPs (ICE Clear Europe Limited, LCH Limited and LME Clear Limited), one CSD (Euroclear UK and International (EUI)).

9.16 HM Treasury has not taken a decision on whether to apply SM&CR to CRAs and RIEs. An additional 15 firms (six RIEs and nine CRAs) could also be affected if, in future, the regime is extended to cover these entities following consultation. These are: six RIEs (IPSX UK Limited, ICE Futures Europe, London Stock Exchange, The London Metal

Exchange Limited, Aquis Stock Exchange Limited and Cboe Europe Limited); and nine CRAs (S&P Global Ratings UK Limited, Moody's Investors Service Limited, Fitch Ratings Limited/Fitch Ratings (CIS) Limited, A.M. Best Europe, Rating Services Limited, ARC Ratings, DBRS Ratings Limited, Kroll Bond Rating Agency UK Limited, Scope Ratings UK Limited, and The Economist Intelligence Unit Limited).

9.17 In line with the approach set out in the FRF Review consultation, the government wishes to implement the regime in a manner which will allow for detailed rules to be set out through secondary legislation and regulators' rules. This approach will also allow the regime to be imposed on different types of entity at different times and to be tailored as appropriate for each regulated sector. In order to meet this objective, the Bill will provide HM Treasury with the power to extend the SM&CR to a specific type of entity through secondary legislation, with certain detailed aspects of the regime set out in regulations and the relevant regulator's rules.

9.18 As part of the FRF Review, this Bill also provides the Bank with a new general rule-making power to make rules for CCPs and CSDs. It also provides the FCA with a new general rule-making power for RIEs. This is in line with the FRF Review approach, where the Bank and the FCA, in their role as the independent, expert regulators , should take on primary responsibility for setting regulatory requirements for these entities. These powers will allow them to address emerging risks and keep pace with international standards, while enabling rule-making to become more agile, responsive and adaptable.

9.19 This Bill will set out:

a. The key elements of the regime which are essential to deliver on the policy intent set out in the "Senior Managers & Certification Regime: Financial Market Infrastructures[157]" consultation ('senior manager functions' require approval, 'specified functions' require certification, conduct rules apply to all employees, regulators can issue prohibition orders), and the powers for the regulator to make detailed rules in relation to these elements of the regime.

b. Requirements which apply to the regulator itself (such as, the requirement to consult another regulator; the requirement to make, refuse or grant approval (with or without conditions); the requirement to issue policy statements).

c. Criminal offences (there will be two criminal offences which will be provided for in primary legislation: breaching a prohibition order and providing false or misleading information).

d. Regulator powers to make detailed provision regarding penalties and disciplinary powers, and issues related to this (such as, the procedure on how to appeal regulatory decisions, the threshold for imposing penalties, the procedure for taking disciplinary action, etc.).

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[157] https://www.gov.uk/government/consultations/senior-managers-certification-regime-smcr-for-financial-market-infrastructures-fmis-consultation

e. Requirement for regulators to publish policy statements on how they plan to implement certain parts of the regime.

9.20 The Bill will establish a ”gateway”, providing HM Treasury with the power to “switch on” the regime in relation to each type of entity covered above. Through this, the Bill will allow HM Treasury to decide when to apply the regime in respect of any one of these types of entity, and for the more detailed requirements of the regime to be set in HM Treasury regulations and regulator rules.

9.21 As the government has not taken a decision over whether to apply SM&CR to RIEs or CRAs, the Bill requires HM Treasury to undertake a public consultation before making any decision on whether to also extend the regime to these firms.

**Methodology**

9.22 The costs and benefits are being compared to a counterfactual where no SM&CR is implemented. As has been noted above, although the government will apply the SM&CR to CCPs and CSDs, a decision has not yet been made on whether to do the same for CRAs and RIEs and this is reflected in the sections below.

9.23 Therefore, the cost estimates below only cover CCPs and CSDs, and are based on a cost-benefit analysis[158] published by the FCA in 2018, which looked at extending SM&CR to solo-regulated firms and insurers. This can potentially be considered to be a broadly similar regime to the one proposed in this Bill, but for a different population of firms. Whilst these firms may be comparable to FMIs, they could still be very different in size and/or nature, and therefore should be taken as merely indicative at this stage, and treated with caution. This analysis highlights the scope of these differences where data is available to do so.

9.24 Although the government has not yet decided to extend the regime to CRAs or RIEs, and no costs or benefits have been estimated for these entities, it is reasonable to assume that the costs of implementing the SM&CR for these firms would be similar. If the regime were to be extended to CRAs or RIEs in the future, the government will produce an additional impact assessment of that change.

9.25 It is also important to note that some of the more detailed requirements of the regime will be set out in the secondary legislation that is enabled by the Bill. Any costs and benefits to firms will be contingent on the exact nature of secondary legislation. HM Treasury will provide a further impact assessment in each instance of a where it makes such secondary legislation. However, to inform an assessment of the Bill the government has set out an illustrative set of potential costs and benefits below.

9.26 At the point of secondary legislation, and in line with the government’s approach to better regulation under the Better Regulation Framework, HM Treasury will make efforts to further consult on and understand the potential further impacts of this measure, including through appropriate stakeholder engagement. More detailed qualitative and quantitative cost-benefit analyses are expected to be covered in the

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158 https://www.fca.org.uk/publication/research/cost-benefit-analysis.pdf

IAs accompanying the relevant secondary legislation enabled by the Bill. HM Treasury will also engage with the RPC, prior to the submission of IAs produced to accompany future secondary legislation where appropriate.

Population within scope of this proposal

*Central counterparties (CCPs)*

9.27 Firms use CCPs to reduce certain risks that arise when trading products on financial markets, such as derivatives and equities markets. They sit between the buyers and sellers of financial contracts, providing assurance that the obligations of those contracts will be fulfilled. Instead of holding the contract with each other, the buyer and seller each hold their side of the contract with the CCP instead. Collateral is placed with the CCP in case any counterparty fails to meet their contractual obligations, so that the CCP can use that collateral to assure the contracts in the case of a default.

9.28 CCPs also have a default fund that can be used to cover losses that exceed a defaulting member's collateral. These pre-funded financial resources at UK CCPs' derivatives clearing services totalled approximately £120 billion on average in 2016. These processes help ensure that if one CCP member defaults and is unable to fulfil its financial obligations to its counterparties, the member's own resources would be used to cover the losses. If members' own resources are not sufficient, the loss would be mutualised amongst the other members of the CCP.

9.29 There are currently three UK CCPs recognised by the Bank:

a. LCH Limited

b. LME Clear Limited

c. ICE Clear Europe Limited

9.30 Given CCPs' important position between buyers and sellers of financial contracts, and that central clearing is mandatory for certain derivatives contracts, any disruption of a CCP has the potential to impact other market participants within the wider financial system.

9.31 It is therefore important that CCPs are both financially and operationally resilient. Financial resilience ensures that CCPs can survive financial shocks, particularly those arising from the failure of one or more market participants to fulfil their obligations to the CCP. Operational resilience enables CCPs to prevent, respond to and recover from operational disruptions. To achieve resilience in both of these areas, CCPs need to ensure that they have sufficient financial resources, risk management arrangements and contingency plans to withstand financial or operational disruptions.

*Central security depositories (CSDs)*

9.32 Amongst other functions, a CSD operates the infrastructure (the securities settlement) which keeps a record of who owns individual securities, such as shares or bonds. It plays a key role when ownership of a security is transferred, including re-

allocating the cash and securities between the relevant market participants and managing all the rights and obligations linked to the ownership of a security (such as corporate action and cash payments arising on the securities).

9.33 There is currently only one CSD in the UK, Euroclear UK and International (EUI). EUI is part of the wider Euroclear Group based in Belgium. On average, 260,000 transactions are processed everyday through EUI's securities settlement system. The daily annual settlement which goes through it is £880 billion[159].

9.34 Without CSDs, modern securities markets could not exist in their current form. CSDs allow for a high volume of securities transactions to be settled in a secure and efficient manner and they also provide a secure record of who owns each security. An operational outage at a CSD, such as an IT failure or cyberattack, could cause significant disruption for financial markets. A failure could mean, for example, that securities would not be able to be traded on UK markets or that investors could lose access to the records of the securities they own.

*Credit Ratings Agencies (CRAs)*

9.35 CRAs perform an integral role within global financial markets by providing judgments on the creditworthiness of a wide variety of financial instruments. Credit rating activities must be conducted in accordance with the principles of integrity, transparency, responsibility, and good governance in order to ensure that resulting credit ratings used in the UK are independent, objective and of adequate quality.

9.36 There are currently nine UK CRAs registered with the FCA, as well as three certified third country CRAs.

9.37 UK firms, such as pension funds or asset managers, may use credit ratings to calculate the overall risk associated with their investments. Additionally, some UK firms, such as banks and insurers, may refer to credit ratings in their prudential capital calculations: the riskier a firm's investments, the more capital they will be required to hold. Investors expect CRAs to provide objective opinions of credit risk based on robust and transparent methodology.

9.38 The impact of CRAs on financial markets is multifaceted, as they rate a range of different securities, issued by a varied number of entities. Changes in the credit ratings of securities can make them more or less attractive investments. For example, downgrading the credit rating of a country or a firm may increase their cost of borrowing. The ratings produced by CRAs can therefore have widespread implications for investors, and the overall stability of global markets.

*Recognised Investment Exchanges (RIEs)*

9.39 RIEs are marketplaces where equities, commodities, derivatives and other financial instruments are traded. The core function of an exchange is to ensure fair and orderly trading and the efficient dissemination of price information for any securities trading on that exchange. For example, the London Stock Exchange has 1977

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[159] https://www.bankofengland.co.uk/news/2021/december/supervision-of-financial-market-infrastructures-annual-report-2021

companies listed as of January 2022 and accounts for over 4% of total world equity value, making it the fourth largest domestic market globally, behind the US, Japan and China.

9.40 There are currently six RIEs that are recognised by the FCA:

a. IPSX UK Limited

b. ICE Futures Europe

c. London Stock Exchange

d. The London Metal Exchange Limited

e. Aquis Stock Exchange Limited

f. Cboe Europe Limited

9.41 Over half of the UK's RIEs are global companies, which makes them vital infrastructure not only to the UK but to countries around the globe. The London Metal Exchange for example is owned by the Hong Kong Exchange. ICE Futures Europe is part of the Intercontinental Exchange (ICE) group, which also owns the New York Stock Exchange. London Stock Exchange, London Metal Exchange and ICE Futures Europe all operate their own UK CCPs, indicating how closely aligned RIEs are with CCPs.

9.42 Exchanges help provide liquidity in the market, and bring buyers and sellers together to make trades. Exchanges also ensure that trading occurs in an orderly and fair manner so important financial information can be transmitted to investors and financial professionals. Given the critical role RIEs play in global financial markets, any disruption of a RIE has the potential to lead to significant financial instability and be a source of stress within the markets.

**Policy Costs**

Transitional costs for firms

*Setting up systems to comply with the regime*

9.43 CCPs and CSDs will have to set up new systems to prepare and submit senior manager applications (including documentation of their responsibilities within the firm), and to check annually that senior managers remain fit and proper.

9.44 The exact number of senior manager roles will be determined by the Bank following consultation with industry. There are c.1000 employees working in CCPs in the UK and c.50 working in CSDs in the UK. It is estimated that there will be 5-20[160] senior manager roles in the UK. Whilst the existing regime covers roles with governing functions, systems and controls functions, as well as other high-level management functions, the number of roles in the proposed regime will be dependent on the Bank's approach to designating senior management functions (SMFs). The FCA

[160] This is based on how many senior manager roles would be required if the current regime for banks was applied to CCPs and CSDs.

(2018)161 cost-benefit analysis, prepared in the context of the consultation on the SM&CR extension to solo-regulated firms and insurers, estimated that the one-off costs for implementing the Senior Managers Regime and the Certification Regime for FCA-regulated firms in the 'enhanced' category would be £432,230 per firm (an estimated £227,210 for the Senior Managers Regime, and up to an estimated £205,020 for the Certification Regime).

9.45 This would cover the following, non-exhaustive, list: changes to the organisational structure; required adjustments to IT systems; staff monitoring associated with Statements of Responsibilities and Prescribed Responsibilities; one-off changes to the checks and processes a firm currently carries out when recruiting and hiring; changes to HR staff structure.

9.46 If this regime was to be extended to CRAs or RIEs they would likely face similar, scaled costs to CCPs and CSDs. These costs would be explored more fully through a consultation process. This analysis therefore focuses on CCPs and CSDs, as the government has taken a decision to extend the SM&CR to these firms, and has conducted a consultation to understand the impact.

*Training for employees at CCPs and CSDs*

9.47 Firms will need to train all employees about how the conduct rules apply to them. For example, firms may incur costs of staff time for training and supervision, or costs of new IT equipment and system changes, which may be needed to document compliance. Some of these costs will be one-off costs such as systems changes. According to the FCA[162], when the regime was extended to solo-regulated firms and insurers, these costs were estimated to amount to approx. £23,820. Once again, this figure should be taken as indicative, due to the fundamentally different size and nature of the entities subject to the proposed regimes, compared to those to whom the existing regime applies.

Ongoing costs for industry

9.48 Under the assumption that the Bank decides to implement the proposed SM&CR in a similar fashion to the existing SM&CR, this could require firms to:

a. Draw up documents showing the allocation of different senior managers' responsibilities within the firm, and update those as roles shift,

b. Establish the necessary systems to request and provide regulatory references,

c. Establish the necessary systems to manage and submit senior manager applications, or to certify individuals covered by the certification regime on an annual basis,

161 https://www.fca.org.uk/publication/research/cost-benefit-analysis.pdf

162 https://www.fca.org.uk/publication/research/cost-benefit-analysis.pdf

d. Ensure employees are aware of the conduct rules that apply to them (e.g. by providing appropriate training)

e. Operate the necessary systems to report regulatory breaches by senior managers and other employees of the firm.

9.49 The FCA[163] cost-benefit analysis also provided a breakdown of the average annual costs per firm subject to the SM&CR. It noted that the annual cost per firm was likely to be between £61,870 and £96,410, depending on the size of the firm. Again, these figures should be taken as indicative in relation to the proposed regime – CCPs and CSDs are fundamentally different in nature compared with solo-regulated firms in the 'enhanced' category. Therefore, this may lead to substantially different cost totals in the proposed regime.

Transitional costs for the Bank

9.50 It is difficult to estimate the one-off costs that the Bank would incur when implementing the new regime. This is due to the fact that the costs incurred by the PRA/FCA when implementing the existing regime cannot be used as a basis for comparison, as the number of firms in the existing SM&CR is significantly higher than the number of firms in the proposed SM&CR. However, it is likely that ongoing costs for the Bank will fall under the following areas:

a. Setting up systems and processes for assessing applications;

b. Supervisory training and support;

c. Costs of developing and publishing SM&CR policy.

Ongoing costs for the Bank

9.51 As was the case for the transitional costs, it is difficult to estimate the ongoing costs that the Bank would incur when implementing the new regime. This is due to the fact that the costs incurred by the PRA/FCA when implementing the existing regime cannot be used as a basis for comparison, as the number of firms in the existing SM&CR is significantly higher than the number of firms in the proposed SM&CR. The Bank will consult on its implementation of the SM&CR in due course. However, it is likely that ongoing costs for the Bank will fall under the following areas:

a. Ongoing cost of operations

b. Enforcement investigations

c. Assessing new senior manager applications for roles

**Policy Benefits**

9.52 Introducing an SM&CR would encourage effective governance within firms, promote high standards of conduct and require employees to give adequate oversight to the areas for which they are responsible. Individual accountability could also encourage employees in FMIs to identify gaps in responsibility within the FMI and to address

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[163] https://www.fca.org.uk/publication/research/cost-benefit-analysis.pdf

them appropriately. The government hopes that the combination of these benefits would improve risk management at these systemically important entities, and therefore their safety and soundness. This would in turn support UK financial stability, which is the overarching goal and benefit of the introduction of the proposed regime. It is therefore important to highlight that each of the benefits outlined below will contribute to the overall goal of protecting and enhancing financial stability, at both the UK and international level.

*Better governance*

9.53 The PRA evaluation[164] found that the SM&CR for banks and insurers has helped ensure that senior individuals in PRA-regulated firms take greater responsibility for their actions, and has made it easier for both firms and the PRA to hold individuals to account. Almost all (around 95%) of the firms surveyed said the SM&CR was having a positive effect on the conduct of individuals.

9.54 Experience of the existing SM&CR to date suggests that it has increased clarity of individual responsibilities, led to better-documented governance arrangements (especially in large, complex banking groups), improved challenge and oversight by boards, and encouraged more effective supervisory engagement.

9.55 This may also lead to clearer lines of responsibility for all employees, as named individuals need to be responsible for different areas. This should lead to better decision making as senior managers, as well as other staff within the firm, have transparency regarding who is responsible for what, and how those responsibilities interact with others within the firm. The Bank would be able to achieve this by making a clear distinction between the different senior management functions.

*Greater confidence in the financial sector*

9.56 Given CCPs' critical position between the buyers and sellers of financial contracts, any disruption at a CCP has the potential to impact other market participants and therefore be a source of stress within the wider financial system. This could reduce the ability of market participants to trade.

9.57 A regime which would bring greater confidence about the stability and sound governance of FMIs would be of benefit to market participants.

9.58 Furthermore, as there is still a market for derivatives outside CCPs (i.e. uncleared derivatives), the government wants to encourage market participants to voluntarily use CCPs. Giving these market participants greater confidence in CCPs, so they choose to move over to the cleared market, will have a beneficial impacts in terms of financial stability.

*Improved employee conduct at all levels*

9.59 The requirements provided by the Senior Managers Regime will lead to more robust staff hiring processes through regular fit and proper checks and regulatory

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164 https://www.bankofengland.co.uk/prudential-regulation/publication/2020/evaluation-of-the-senior-managers-and-certification-regime

references. Furthermore, Conduct Rules will ensure that people working at all levels in their areas of responsibility meet appropriate standards of conduct and competence.

9.60 The Certification Regime will also make firms more accountable for the suitability of their staff. The Regime requires firm to check and confirm ('certify') that those below senior managers, who are performing roles which could have significant impact on the firms or its customers, are fit and proper to do so. This should further drive-up standards.

*Clearer division of responsibility within firms*

9.61 The new policies will encourage the clear allocation of management responsibilities among senior managers. This will, for example, make it easier for the Bank during an investigation, and indeed for the firms themselves, to identify the senior managers responsible for the areas of the business where misconduct occurred. If senior managers perceive that the regulator is likely to take action against them where they are at fault for misconduct, rule breaches by their firms should be less likely to occur.

9.62 In addition, Conduct Rules will apply beyond senior managers to cover a much broader range of employees within firms than under the current system. This will allow the regulator to pursue wrongdoing in firms wherever it is found, without the technical restrictions that can prevent action at present. This should incentivise better firm conduct and culture.

**Assumptions, limitations, and considerations**

9.63 The costs and benefits outlined in this assessment are based on the assumption that the proposed SM&CR will be implemented in the same way as the PRA and FCA chose to implement the existing SM&CR. However, it is likely that the relevant regulators (Bank and FCA) may choose to apply the regime differently. The figures provided should therefore be interpreted as a reasonable proxy.

9.64 The cost estimates are based on a cost-benefit analysis[165] published by the FCA in 2018, supporting the extension of the SM&CR to solo-regulated firms and insurers. Whilst the tasks required to implement the SM&CR for these firms may be comparable to the tasks CCPs and CSDs would face, these firms could still be very different in size and/or nature to CCPs and CSDs, and therefore all figures should be taken as purely indicative.

9.65 It is difficult to quantify the current levels of misconduct at FMIs, due to the fact there is no regime which currently requires misconduct at these entities to be reported. However, any misconduct could potentially lead to large and significant implications for financial stability in the UK. By implementing the proposed SM&CR, the likelihood of instances of misconduct being identified will increase, through the application of Conduct Rules and associated reporting requirements.

**Small and MicroBusiness Assessment (SaMBA)**

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165 https://www.fca.org.uk/publication/research/cost-benefit-analysis.pdf

Number and distribution of businesses in scope of the regulation

9.66 This measure applies only to UK CCPs and CSDs – there are 3 CCPs in the UK and one CSD[166], all of which are authorised and supervised by the Bank. All of these firms are part of large multinational groups with well over 50 employees. Specific firm-level data on the number of employees is not available, but based on public financial statements none of these firms could be classed as small businesses when considering turnover data as they all have annual turnover over £10m.[167]

9.67 No future CCP or CSD established in the UK is expected to be a small or microbusiness - any new entrant to the market would likely be one part of a large financial services group, as is the case with the current set of firms. The services that CCPs and CSDs provide are technically complex and would require a level of investment to set up and run which is likely beyond the means of any small or microbusiness. The nature of the markets in which these firms operate also does not lend itself to small-scale competitors. Due to the strong economies of scale in the clearing market for instance, the global market for specific products can be dominated by an individual firm and it would be challenging for a small or microbusiness to compete in terms of liquidity or pricing. CSDs are more domestic in nature but, given the nature of the services they provide, there tends to only be one CSD per jurisdiction.

Do the impacts fall disproportionately on small and microbusinesses?

9.68 No small or microbusinesses are directly impacted by the measure, therefore the impacts do not fall disproportionately on them. As the regime's costs primarily involve setting up systems to comply with the regime, as well as providing training for employees, they will fall solely on the entities that the SM&CR applies to directly (i.e., CCPs and CSDs), and therefore small and microbusinesses will bear no indirect costs. The indirect benefits to small and microbusinesses are the same as the wider benefits the regime will bring to the financial sector: by improving risk management and governance arrangements at CCPs and CSDs, the new SM&CR will support UK financial stability and minimise the likelihood of small and microbusinesses being affected by issues at these firms.

Could small and microbusinesses be exempted while achieving the policy objectives?

9.69 As small and microbusinesses are not directly affected, there is no need to exempt them.

Could the impact on small and microbusinesses be mitigated while achieving the policy objectives?

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166 https://www.bankofengland.co.uk/financial-stability/financial-market-infrastructure-supervision

167 https://www.lch.com/system/files/media_root/2021_lch_group_stat_accounts_ey.pdf; https://www.ice.com/publicdocs/clear_europe/ICE_Clear_Europe_Limited_Statutory_Accounts_2021_UK_GAAP.pdf; https://www.lme.com/about/governance/lme-clear-governance/Financial-statements; https://www.euroclear.com/content/dam/euroclear/investor-relations/annual-reports/2021/Documents/IR4311_EUI_Financial_Statements_2021.pdf

9.70 As there is no direct impact on small and microbusinesses, there is no need to mitigate the impact.

Wider impacts on small and microbusinesses

9.71 Whilst the regime does not apply to small and microbusinesses directly, introducing an SM&CR for CCPs and CSDs will give all market participants (including small and micro businesses) greater confidence in these entities and would potentially encourage their use in certain situations. More broadly, by improving risk management at CCPs and CSDs, as well as their safety and soundness, the SM&CR will support UK financial stability, which in turn will benefit small and microbusinesses.

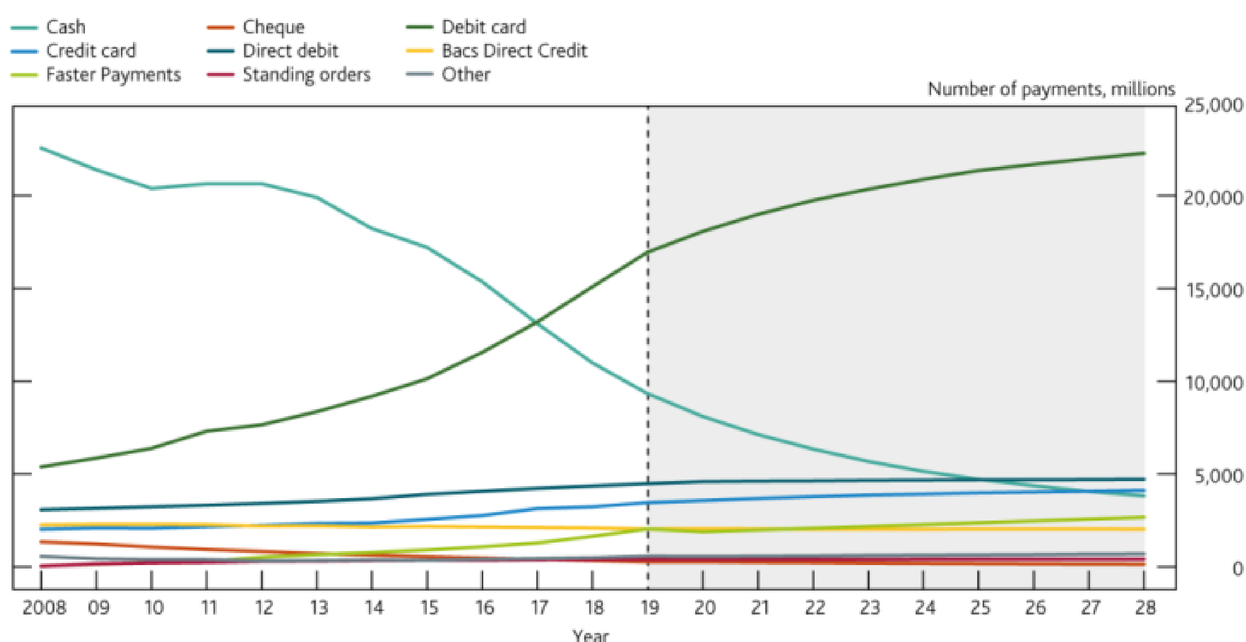
# Financial inclusion and levelling up

## Background to Access to Cash (Retail and Wholesale)

10.1 The way people make payments in the UK is changing. The ongoing trend over the past decade has been away from cash and towards card payments and other digital payment methods. The adoption of digital payments offers many opportunities to the people and businesses that use them, including convenient, tailored, and flexible ways of making and managing payments safely and securely.

10.2 While the use of digital payment methods has increased in recent years, cash usage in the UK has fallen from 58% of transactions in 2009 to 23% in 2019, and 17% in 2020. The COVID-19 pandemic also had an impact on cash use. Although there may be some recovery in the trends around cash-use relative to this period, the long-term trend is towards decline in both the number and proportion of cash transactions.

Figure 10.A: Historical and forecasted consumer payment volumes (millions) 2008-28[168]




Source: UK Finance, 2019 and 2020 UK Payment Markets Report.

10.3 While the government welcomes the potential benefits associated with digital payments, it recognises that there may not yet be a suitable option for many people and businesses who still rely on notes and coins. Cash remains an essential form of payment for many groups, including the elderly, and people in lower socio-economic

168 https://www.bankofengland.co.uk/-/media/boe/files/paper/2020/consultation-on-the-future-of-the-uks-wholesale-cash-distribution-model.pdf?la=en&hash=D9B4FB7B6CA6FD3F846E5C277AE3BB8D20F2B928 Notes: the underlying 2008–19 historic data is taken from the Payment Markets Report published in 2020; the 2020-28 forecast data is taken from the Payment Markets Report published in 2019. UK Finance did not provide forecast data in its 2020 and 2021 report.

groups. The FCA's 2020 Financial Lives Survey found that over 5 million people were reliant on cash.

10.4 As part of the 2020 Budget, the government committed to bringing forward legislation to protect access to cash and ensure that the UK's cash infrastructure is sustainable in the long term[169].

10.5 There are three major parts to UK's cash infrastructure:

a. Cash Production: A third-party contractor prints Bank of England (Bank) banknotes and commercial banks and Scotland and Northern Ireland are authorised to issue Scottish and Northern Irish banknotes. The Royal Mint produces and issues coins on behalf of HM Treasury.

b. The wholesale cash network: The wholesale industry purchase new banknotes from the Bank and coins from the Mint at face value and facilitates the process of passing these to bank branches, ATMs, retailers and the Post Office; it collects, sorts, packages and stores cash deposited by the public and businesses before returning it to circulation when needed; withdraws notes and coins that are no longer fit for circulation from the system to be destroyed.

c. The retail cash network: The UK's network of facilities such as banks, Post Office branches, and ATMs that receive cash distributed by the wholesale cash network and provides withdrawal and deposit services. The retail network enables the public to access cash.

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169 https://www.gov.uk/government/publications/budget-2020-documents/budget-2020

## Access to Cash (Cash Access Services)

**Problem under consideration**

11.1 While the convenience, security, and speed of digital payments brings opportunities to the businesses and individuals that use them, the ability to use and transact in cash is an important part of daily life for millions of people across the UK. For individuals and businesses to be able to use cash, it is important that they can access suitable cash withdrawal and deposit facilities near to where they live and work.

11.2 Once banknotes and coins have been created and distributed out to the economy, there are several different ways that people are able to withdraw them; these include:

a. Automated Teller Machines (ATMs)

b. Over the counter at a bank or building society

c. Post Office branches

d. Retailers offering cashback

11.3 There are also various means by which cash users can make deposits. Deposit-taking facilities are particularly important for smaller businesses who may deposit significant sums of cash on a regular basis. The PSR found that 55% of cash-accepting businesses deposited cash at least weekly[170]. Deposit-taking facilities include:

a. Bank or building society branches

b. Post Office branches offering banking services

c. Cash collection services

11.4 The UK retail cash network comprises the facilities that individuals and businesses use to withdraw and deposit cash. There are an estimated 59,728 free-to-use cash access points with a further 429,482 cashback locations across the UK.[171]

11.5 These facilities are generally provided by account providers (e.g., banks and building societies) or by third parties, such as independent ATM deployers or the Post Office, through voluntary arrangements with account providers.

11.6 In terms of usage, while the adoption of digital payments continues, cash remains the second most frequently used payment method in the UK (behind debit cards). Nonetheless, over the past decade the UK has witnessed a decline in the use of cash in favour of card and other digital payment methods. Cash represented 17% (6.1

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170 Access to cash research with consumers and small businesses, Payment System Regulator and BritainThinks (2019) https://www.psr.org.uk/media/qnslp3ma/psr-access-to-cash-full-report-july-2019.pdf

171 Access to cash coverage in the UK 2021 Q3, Financial Conduct Authority (2022), https://www.fca.org.uk/data/access-cash-coverage-uk-2021-q3

billion) of the total number of payments made in the UK in 2020.[172] This is a reduction from 56% in 2010.

11.7 There is evidence of similar trends internationally. For example, in New Zealand the percentage of household payments made in cash has declined from 30% in 2007 to 13% in 2019[173]. Similarly, in Sweden the use of cash has declined in the last decade. According to the Swedish Riksbank 9% of the people paid for their most recent purchase in cash in 2020. This was down from 39% in 2010[174].

11.8 The transition away from cash towards card payments and other digital payment methods and the reduced number of times that cash access facilities are used to withdraw and deposit cash as a result, has made it relatively more expensive for firms that provide cash access services to maintain the existing infrastructure needed for current levels of access to cash to continue. In response, firms have consolidated their cash facilities in recent years, reducing the overall number of cash access points across the UK.

11.9 For ATMs, or cash machines, a fall in the volume and value of cash withdrawals has preceded a reduction in the number of free-to-use ATMs across the UK. The number of ATM withdrawals for 2020 and 2021 (1.3 billion) was around 40% lower compared to 2019. The total value of cash withdrawals from the LINK network, which is the UK's largest ATM network, peaked in 2012 and has declined since, reaching £116 billion in 2019, £81 billion in 2020, and £79 billion in 2019. LINK reports that the number of free-to-use ATMs on its network has decreased from a peak of 54,599 in 2017 to 40,942 in 2021.[175]

11.10 The number of bank and building society branches across the UK has also declined. According to the Office for National Statistics (ONS) between 2012 and 2021 the total number of bank branches and building society branches in the UK fell by 34%, from 13,345 in 2012 to 8,810 in 2021.[176]

11.11 The number of Post Offices has remained broadly stable since 2009.[177] Post Offices provide 99% of personal banking and 95% of business customers with everyday

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172 UK Payments Report (2021), UK Finance, https://www.ukfinance.org.uk/sites/default/files/uploads/SUMMARY-UK-Payment-Markets-2021-FINAL.pdf

173 Future of money, Reserve Bank of New Zealand (2021) – https://www.rbnz.govt.nz/have-your-say/closed-consultations/future-of-money---cash-system-te-moni-anamata---punaha

174 Payments Report, Sveriges Riksbank (2021) https://www.riksbank.se/globalassets/media/rapporter/betalningsrapport/2021/engelska/payments-report-2021.pdf

175 Statistics and trends, (LINK) https://www.link.co.uk/about/statistics-and-trends/

176 Statistics on access to cash, bank branches and ATMs, House of Commons Library (October 2021). ONS data is based on VAT and PAYE returns of ‘local units’ (also referred to as individual sites or workplaces) in the Bank (Standard Industrial Classification (SIC) code 64.19/1) and Building Society (SIC code 64.19/2) industries. The source notes that a few of these local units may not be branches. https://researchbriefings.files.parliament.uk/documents/CBP-8570/CBP-8570.pdf

177 Post Office Numbers, House of Commons https://commonslibrary.parliament.uk/research-briefings/sn02585/

banking services as an alternative to bank and building society branches. As of the third quarter of 2021, there were 11,645 post offices in the UK.[178]

11.12 Other services such as cashback, where customers of a shop are able to withdraw money over-the-counter, or cash collection, where cash can be collected directly from an individual or business and deposited, can offer alternative methods to access to cash. However, these services may not be suitable in all situations. For example, the availability of cashback may be dependent on the levels of available cash at each individual retailer, and the suitability of cash collections may be limited due to considerations such as the timing and cost.

11.13 Despite a long-term decline in the use of cash in favour of card payments and digital payment methods, cash remains an important payment method for millions of people across the UK. An estimated 5.4 million adults (10%) report as reliant on cash to a very great or great extent in their day-to-day lives.[179] Meanwhile, the use of alternatives, such as cards and digital payments, is not yet a realistic alternative for many people - who still rely on notes and coins - or in all situations. For individuals and businesses to be able to use cash, it is important that they can access suitable cash withdrawal and deposit facilities.

11.14 To date, the market has provided sufficient access to support people's use of cash. The FCA assess that the geographic coverage of cash facilities across the UK remains good; over 95% of the UK population is currently within 2 kilometres of a free-to-use cash access point.[180]

11.15 However, the decline in cash usage and consolidation of cash facilities risk affecting the ability of individuals and businesses who rely on cash to continue to access it over the long-term. There is a risk the consolidation of facilities may be uncoordinated and could reduce the geographic coverage of facilities to an extent that the provision of facilities does not meet the needs of consumers and businesses.

11.16 At present no single authority has overarching responsibility for the cash system. The government and financial services regulators (the FCA, PSR, and the Bank of England (Bank)) each have various roles and responsibilities:

a. HM Treasury has responsibility for financial services public policy and legislation, including setting the objectives and remits for the financial regulators.

b. The FCA is the conduct regulator for financial services firms and financial markets in the UK.

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178 Access to cash coverage in the UK 2021 Q3, Financial Conduct Authority (2022) https://www.fca.org.uk/data/access-cash-coverage-uk-2021-q3

179 Financial Lives 2020 survey: the impact of coronavirus, Financial Conduct Authority, (2021) https://www.fca.org.uk/publication/research/financial-lives-survey-2020.pdf

180 Access to cash coverage in the UK 2021 Q3, Financial Conduct Authority, (2022) https://www.fca.org.uk/data/access-cash-coverage-uk-2021-q3

c. The PSR has statutory responsibilities to promote the interests of businesses and consumers that use payments systems, as well as to promote competition and innovation within payment systems. It is responsible, along with the Bank, for regulating the payment system LINK.

d. The Bank has primary functions to maintain monetary stability and oversee the stability of the UK financial system. It regulates systemically important payment systems, including LINK. The Bank is also responsible for producing and issuing banknotes in England and Wales.

**Rationale for intervention**

11.17 As the adoption of digital payments continues, the consolidation of cash facilities risks affecting the ability of individuals and businesses who rely on cash to continue to access it over the long-term. The government believes that intervention is necessary to protect access to cash for those who need it, and to avoid an uncoordinated approach to consolidation that could reduce the geographic coverage of facilities to an extent that the provision of facilities does not meet the needs of consumers and businesses.

11.18 At present there is no substantive legal framework relating to reasonable levels of access to cash and no regulator currently has express powers to ensure that a cash withdrawal or deposit facility is in place to support access to cash.

11.19 Therefore, the government considers legislative intervention to be necessary. At Budget 2020, the government committed to introduce legislation to protect access to cash for those who need it.[181] The government issued a Call for Evidence[182] on the key considerations associated with cash access, including deposit and withdrawal facilities, cash acceptance, and regulatory oversight of the cash system in October 2020. Subsequently, the government published a consultation[183] which sought views on legislative proposals in July 2021.

11.20 The government received responses to the consultation from a broad range of respondents, including firms within the banking and wider financial services sector, consumer organisations, trade bodies, charities and individuals. Responses recognised that access to cash remains an important part of daily life to millions of people in the UK and were overwhelmingly supportive of the government introducing legislation in order to protect access to cash. The responses the government received have helped to shape the legislative proposals included in the Bill.

11.21 Ensuring that the provision of cash remains sustainable at lower levels of usage also requires a well-functioning wholesale cash distribution network. The Bill also

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181 Budget 2020, HM Treasury (2020) https://www.gov.uk/government/publications/budget-2020-documents

182 Access to Cash: Call for Evidence, HM Treasury, (2020) https://www.gov.uk/government/publications/access-to-cash-call-for-evidence

183 Access to Cash Consultation, HM Treasury, (2021) https://www.gov.uk/government/consultations/access-to-cash-consultation

introduces legislation regarding oversight of the wholesale cash network (see Chapter 12 of this Impact Assessment).

11.22 Beyond the UK, several countries in Europe are also introducing a range of legislative and non-legislative initiatives to ensure the provision of access to cash facilities.[184] For example, Norway has placed an obligation on banks to accept cash and make cash available for deposit holders. In 2021, Sweden introduced requirements on its largest banks to offer cash services for withdrawals and deposits and empowered the Swedish Financial Supervisory Authority to take action against those institutions[185]. In countries such as Spain, Belgium, and Germany various non-legislative and market-led initiatives have been established. These include ensuring the majority of the population has access to an ATM with a pre-determined distance (similar to the commitments made by LINK and overseen by the PSR), ATM pooling to reduce facility costs on service providers, and pilot hubs to facilitate access to cash services for small businesses. In the Netherlands, in 2019, three major banks established the Geldmaat, which allows automated cash deposits for accounts with those banks, as well as ATM withdrawals through participating card schemes[186].

**Policy Objective**

11.23 The government's objective for this measure is to protect access to cash, particularly for consumers in vulnerable circumstances who rely on cash and ensure that the UK's cash infrastructure remains sustainable in the long term.

11.24 The government aims to ensure the continued provision of cash facilities for cash users. In devising its overarching approach to legislation, the government has worked according to the principles, set out in its consultation: to be proportionate – in addressing the needs of individuals and businesses; to allow flexibility – as the cash landscape continues to evolve; to be cost-effective, efficient, and sustainable – allowing industry to determine the best solutions; and to support competition and innovation – allowing industry to identify new solutions through time.

**Description of Options Considered**

11.25 Option 0 (Do nothing) - Engagement with industry within existing regulatory responsibilities and powers (counterfactual): Under this option, the government and financial services regulators would continue to monitor cash access within their existing regulatory responsibilities and powers, and engage with industry to develop additional voluntary initiatives to support access to cash.

11.26 To date, HM Treasury, the PSR, the FCA and the Bank have coordinated their activities with regards to cash, including through the Joint Authorities Cash Strategy

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[184] Report of the ERPB Working Group on Access and Acceptance of Cash 2021, Euro Retail Payments Board (ERPB) https://www.ecb.europa.eu/paym/groups/erpb/shared/pdf/16th-ERPB-meeting/Report_from_the_ERPB_working_group_on_access_to_and_acceptance_of_cash.pdf

[185] Obligation for major banks to provide certain cash services, Sveriges Riksbank, https://www.riksdagen.se/sv/dokument-lagar/arende/betankande/skyldighet-for-kreditinstitut-att-tillhandahalla_H701FiU29

[186] Geldmaat (2022) https://www.geldmaat.nl/information-english/our-cash-and-deposit-machines

(JACS) Group[187], and engaged with industry to support several initiatives to help protect access to cash.

11.27 However, the government does not consider that the range of initiatives in place – as summarised below – and existing regulatory powers will be sufficient to ensure access to cash for those who it need for the long-term. As a result, the government committed to legislate at Budget 2020.

11.28 In relation to the ATM network, LINK has operated a Financial Inclusion Programme since 2006, which has led to the introduction of free-to-use ATM access to over 1,800 deprived areas in the UK. In 2018, LINK committed to maintaining an extensive network of free-to-use ATMs with a wide geographic footprint.[188]

11.29 The PSR issued a Direction on LINK to require it to maintain policies and processes for implementing its commitments: Specific Direction 8.[189] Specific Direction 8 has been important in ensuring the right incentives and requirements are in place to secure free-to-use ATM provision in more rural, less populated communities, while avoiding the over-provision of ATMs in highly populated areas. The PSR issued an updated Specific Direction on LINK in March 2022, which maintained obligations on LINK to continue to meet its commitments to protect the geographic footprint of free-to-use ATMs.[190]

11.30 In response to the consolidation of branch networks, in 2015, the major high street banks collectively agreed to a protocol on bank branches closures (later known as the Access to Banking Standard), which commits them to ensure customers are well informed about branch closures, the bank's reasons for closures and options for continued access to banking services, such as the Post Office. In January 2017, the Post Office agreed a three-year voluntary contractual arrangement with 28 UK firms to provide Everyday Banking through the Post Office branch network, known as the Banking Framework. In January 2022, the Post Office announced a further 3-year agreement which will come into effect from 2023. 30 retail banks, building societies and credit unions have signed up to the new agreement. The FCA has also published guidance[191] setting out its expectations of firms when they are deciding to close a branch or free-to-use ATM.

11.31 The government has already introduced changes to the law in relation to cash access as part of the Financial Services Act 2021 (FSA 2021) to allow for the provision of cashback without a purchase. This allowed a shop, newsagent, or other retailers to

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187 Joint Authorities Cash Strategy Group (2020) https://www.gov.uk/government/publications/joint-authorities-cash-strategy-group-update

188 LINK Policy on Protected ATMs, LINK (2021), https://www.link.co.uk/media/1437/protected-atm-policy-v51.pdf

189 Specific Direction 8, Payment Systems Regulator (2018) https://www.psr.org.uk/publications/general/specific-direction-8/

190 Specific Direction 12, Payment Systems Regulator, (2022) https://www.psr.org.uk/publications/general/specific-direction-12/

191 FG 20/3: Branch and ATM closures or conversions, Financial Conduct Authority, https://www.fca.org.uk/publication/finalised-guidance/fg20-03.pdf

provide a customer with cash without the need for them to purchase goods or services. Before the FSA 2021, retailers had to be authorised or registered by the FCA or act as an agent of a payment service provider to do so, which was a significant barrier to widespread provision of cashback without a purchase.

11.32 Following the government's commitment to legislate, in December 2021, the financial services sector announced that it was developing a voluntary industry model that incorporates the different types of facility that provide cash access, including initiatives to provide shared services, to protect access to cash[192]. This has been facilitated through the Cash Action Group, which is chaired by UK Finance and consists of major retail banks and building societies, consumer groups, Post Office and LINK.

11.33 Under the model, LINK undertakes a coordinating role to monitor and assess the access to cash needs of local communities. Where LINK considers local cash provision to be unsuitable following the closure of a cash service it will make recommendations for alternative services to be put in place. In February 2022, the Cash Action Group announced it has established a Banking Hub company to oversee the rollout of the services recommended by LINK.

11.34 In July 2022, the Cash Action Group extended this model to allow communities to request a cash access review, for example where communities are not facing the closure of a cash facility but may have existing issues relating to access to cash due to historic poor provision or closure.

11.35 While this is positive progress, without any existing substantive legislative framework, regulatory authorities have limited scope to monitor and intervene in industry developments in a substantive capacity to ensure industry initiatives meet consumer needs for the long-term. Therefore, the government has concluded not to pursue the option of relying on engagement with industry within existing regulatory responsibilities and powers.

11.36 Option 1 (Preferred Option) - Legislate to amend regulatory responsibilities and powers, to enable effective oversight of the retail cash system (Preferred Option): Under this option, the government would implement legislation to create and amend regulatory responsibilities and powers for oversight of the UK's retail cash system and ensure reasonable levels of access to cash. The government expects this option to be most effective at achieving its objectives for protecting access to cash for those who need it. It is therefore the government's preferred option.

**Outline of preferred policy**

11.37 The Bill places a requirement on HM Treasury to set out the government's policy for access to cash in a policy statement. The Bill allows for HM Treasury's policy statement to set policies in relation to withdrawal and deposit facilities and urban and rural areas. The government intends to determine its policy on the basis of

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192 Cash Action Group (2021) https://www.ukfinance.org.uk/press/press-releases/pivotal-moment-banks-consumer-groups-post-office-and-link-join-forces-help-protect-cash-services

information provided by, and engagement with, the FCA. This approach allows for access to remain proportionate in meeting cash needs and demands over time.

11.38 The Bill empowers HM Treasury to designate banks and building societies to be subject to FCA oversight in relation to the provision of access to cash withdrawal and deposit facilities. The ability to enable designation in this way, rather than in primary legislation, will allow HM Treasury to keep designation under review and ensure that it continues to reflect the appropriate set of banks or building societies as the market evolves over time.

11.39 The Bill enables HM Treasury to take factors into consideration when undertaking designation decisions: a firm's geographic coverage; distribution of customers; and market share (in terms of both number of accounts and value of retail deposits). On the basis of these criteria, the government expects to designate the largest banks and building societies, as cash withdrawal and deposit services are generally made available to customers through accounts provided by such firms. HM Treasury will engage with the lead regulator and firms ahead of any designation.

11.40 The legislation gives HM Treasury powers to designate firms for Great Britain, Northern Ireland or the United Kingdom. This is to account for differences in market structure. There is evidence that the retail banking markets of Great Britain and Northern Ireland are distinct, with several dominant retail banking service providers, in terms of market share, that operate in Northern Ireland only.[193]

11.41 The Bill also provides HM Treasury with powers to designate operators of industry cash coordination arrangements that have the purpose of coordinating activity in relation to cash access.

11.42 The Bill does not mandate designated firms to provide withdrawal or deposit facilities using specific types of facility, such as ATMs; instead, firms will be able to determine the best means to provide access, subject to criteria that may be set by the regulator. The underlying rationale for this approach is that the existing methods of withdrawing and depositing cash may become less financially sustainable for firms as cash use declines. The government's view is that industry is best placed to develop the most efficient and sustainable solutions, working within the regulatory framework.

11.43 To ensure there is sufficient regulatory oversight, the Bill places responsibility on the FCA to seek to ensure reasonable provision of cash access. This establishes the FCA as the lead regulatory authority with overarching regulatory responsibility for retail access to cash.

11.44 The Bill gives the FCA this responsibility on the basis that the appropriate provision of cash withdrawal and depositing facilities are the two most significant factors in maintaining access to cash. Deposit-taking institutions provide both of these facilities already, and have an existing regulatory relationship with the FCA, which has powers to make rules in relation to deposit-taking as a regulated activity. The government

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[193] Competition and Markets Authority – Retail banking market investigation, 2016 https://assets.publishing.service.gov.uk/media/57ac9667e5274a0f6c00007a/retail-banking-market-investigation-full-final-report.pdf

sought views on making the FCA the lead regulatory authority for access to cash in its consultation, and there was broad support for the proposal from respondents.

11.45 The Bill provides the FCA with powers for the purpose of seeking to ensure the reasonable provision of cash facilities. This enables the FCA to make rules, issue directions and take supervision and enforcement action against designated firms and cash coordination arrangements in relation to access to cash. These powers are similar to its powers in other financial services legislation. The Bill also provides the FCA with information gathering powers in relation to all providers of cash facilities, not just those designated by HM Treasury.

11.46 In carrying out its regulatory functions, the Bill requires the FCA to have regard to the Treasury's policy statement and any local deficiencies in the provision of access to cash facilities that it is aware of and considers to be significant. The Bill also allows the FCA to take account of other matters it considers appropriate. The FCA is developing its regulatory approach and will consult in due course.

11.47 Alongside the FCA, the government intends that the PSR and the Bank will continue with their existing functions in relation to payment systems to support consumer and business needs regarding the retail distribution of cash.

**Methodology**

11.48 This measure has been assessed against the counterfactual of option 0 – engagement with industry within existing regulatory responsibilities and powers.

11.49 It is difficult to provide precise quantitative estimates at the primary legislative stage, for example because further decisions on a policy statement, designation and the FCA's rules will be set out at a later date. However, where possible HM Treasury has provided indicative monetary estimates. To assess the costs and benefits HM Treasury has used publicly available information from regulatory authorities and the financial services industry.

11.50 The FCA will conduct a cost benefit analysis associated with any rules resulting from the legislation, or provide a statement and explanation where it does not deem this to be required; for example, due to costs being of minimal significance or where a delay would be prejudicial to the interest of consumers.[194]

11.51 To inform an assessment of the Bill the government has set out the possible costs and benefits based on the level of policy detail provided in the Bill. It is important to note however that the below costs and benefits are illustrative and any costs and benefits to firms will be contingent on the exact nature of related products, such as FCA rules.

**Population within scope of this policy proposal**

11.52 The Bill will empower HM Treasury to designate banks and building societies to be subject to the FCA's oversight in relation to the provision of access to cash

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[194] How we analyse the costs and benefits of our policies, Financial Conduct Authority, https://www.fca.org.uk/publication/corporate/how-analyse-costs-benefits-policies.pdf

withdrawal and deposit facilities. Owing to the type of entity and criteria for the designation of banks and building societies, HM Treasury expects the firms it will designate will be large sized only. It also empowers HM Treasury to designate industry cash coordination arrangements, who would be subject to FCA oversight. As set out above, decisions on firm designation will be made later, and implemented through designation orders.

11.53 The Bill also provides the FCA with powers relating to information gathering for any entities that may hold information relevant to the FCA's functions as the lead cash regulator, and not just those entities designated by HM Treasury.

11.54 Further information on the distribution of firms is provided in the Small and Micro-Business Assessment.

**Policy Costs**

Transitional costs to firms

*Familiarisation and set up costs*

11.55 To comply with new requirements affected entities will need to familiarise themselves with the relevant primary legislation, related policy statement and designation orders, and any accompanying FCA rules and guidance. Entities that will be affected include any individual firms and industry cash coordination arrangements that may be designated, as well as non-designated firms that may be within scope of FCA information powers due to their role in the retail cash system. Designated firms and many involved in the provision of cash access will already liaise regularly with the FCA or other financial services regulators, for example to share information. Therefore, it is anticipated that the transition to complying with the regime should be relatively simple for many, given their familiarity with existing processes. Quantifying the familiarisation costs will only be possible once the FCA has finalised its rules.

11.56 The FCA may incur one-off costs in relation to setting rules and guidance, and developing systems for monitoring and enforcement resulting from the legislation. It is not possible to quantify these costs at this stage.

Ongoing costs to firms

*Administration and Compliance*

11.57 Firms and industry cash coordination arrangements that are designated by HM Treasury will need to remain compliant under the legislation. This is expected to involve additional administrative burdens for these firms. Additional compliance activities may include: supplying requested information to the FCA; cooperating with FCA-issued directions, and inspections or reports on the discharge of their requirements; conducting assessments of cash access where there is potential for significant adverse impacts; and monitoring internal compliance with any FCA rules and guidance.

11.58 Beyond designated firms, the FCA will also be able to use its powers to collect information from firms involved in the provision of access to cash facilities, for

example to inform FCA's monitoring of the coverage of access to cash. These firms largely already report data on their facilities to the FCA - for example to inform the FCA's existing publication on the coverage of cash access. Therefore, HM Treasury expects the additional impact on these firms to be small.

11.59 The FCA may incur ongoing costs as it takes on its additional responsibilities for the retail cash system. The FCA may need to allocate additional resource to meet its responsibilities, including to maintain IT systems and assessment techniques to appropriately monitor the provision of access to cash and enforce compliance.

11.60 Quantifying administration and compliance costs will only be possible once the FCA has finalised its rules.

*Operating Cash Facilities*

11.61 The Bill will empower HM Treasury to designate banks and building societies to be subject to FCA oversight relating to the provision of withdrawal and deposit facilities. HM Treasury will be required to set out the government's policy for access to cash facilities.

11.62 HM Treasury anticipates that the impact of designation will mean firms maintain over time a higher number of cash facilities than under the baseline (counterfactual) scenario. This will create an ongoing relative additional cost for designated firms.

11.63 It is not possible to determine the number of facilities that will be maintained by industry to meet requirements to provide reasonable access. The private sector will continue to be best placed to determine the type and placement of individual facilities, working within the framework resulting from the legislation, and it is possible that designated firms will be able to reduce overall costs through innovation and efficiencies. For example, industry has announced the introduction of shared banking hubs through the Cash Action Group, which may affect the number and distribution of cash access points[195]. Competition within the market is also expected to continue to drive innovation in the type of facilities and industry may choose to offer additional services, for example multiple facilities may continue to be provided in areas with high demand.

11.64 To provide an indication of the potential costs, HM Treasury has provided scenario-based analysis. This indication of potential costs is based on the annual cost of operating all cash facilities by linking the estimated average cost of a facility and scenarios for the total number of cash facilities.

11.65 Owing to the range of factors that may affect the scenario-based analysis, this should not be interpreted as a forecast of what HM Treasury thinks *will* happen, but rather an exploration of what *could* happen.

11.66 There is limited existing publicly available data on the costs of operating individual cash facilities. To determine costs relating to facilities, HM Treasury has estimated an average annual cost per facility for branches (excluding mobile branches) and free-

195 Cash Action Group (2021) https://www.ukfinance.org.uk/press/press-releases/pivotal-moment-banks-consumer-groups-post-office-and-link-join-forces-help-protect-cash-services

to-use ATMs, and for cash and banking services provided by the Post Office per branch. These facilities account for the majority of the UK's free-to-use retail cash network. However, these facilities, such as bank branches, may also provide other services that do not relate to the provision of cash access. Furthermore, as firms develop innovative solutions, such as shared services, the mix of facilities may change and costs per facility may decline. As a result, the average cost is likely to represent an over-estimate for costs relating to access to cash. The approximate costs are:

a. Bank or building society branch: £377,000[196]

b. Free-to-use ATMs: £30,000[197]

c. Post Office branch: £16,000[198]

11.67 There is limited publicly available data on either the potential future coverage of cash access facilities, or the number of cash access facilities. In 2019, industry published forecasts that expected the volume of payments in cash to continue to decline until 2028, but suspended forecasts of trends in payments in its 2020-2021 report[199] due to the impacts of COVID-19.

11.68 In order to provide an indication of the potential future costs under the legislation, HM Treasury has developed a counterfactual scenario using existing trends in the number of cash facilities. Since 2017, the number of bank or building society branches and free-to-use ATMs have decreased by around 6.4%[200] and 6.9%[201] on average each year, while the number of Post Offices has remained broadly stable. The counterfactual scenario assumes there are around 59,000 facilities at the beginning of the forecast period based on the analysis published quarterly by the

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196 Based on dividing the total estimated annual cost of the branch network by the number of branches. The FCA estimated the total annual cost of the branch network of surveyed firms in 2017 at £4.4 billion. There were 11,675 branches in 2017, according to the ONS. See Financial Conduct Authority - Strategic Review of Retail Banking Business Models, 2018 https://www.fca.org.uk/publication/multi-firm-reviews/strategic-review-retail-banking-business-models-final-report.pdf.

197 This estimate has been applied as an average annual cost to all free-to-use ATMs. The annual cost of an ATM at a branch is estimated at £19,000 and £33,000 at other locations. HM Treasury has engaged with the industry trade body and ATM scheme to ensure this estimate is of a reasonable scale -https://publications.parliament.uk/pa/cm200405/cmselect/cmtreasy/191/19104.htm#n22. LINK publishes a breakdown of ATMs located in branches and ATMs located in other locations - https://www.link.co.uk/about/statistics-and-trends/

198 Post Office branches provide a range of services. Average cost for this analysis is estimated based on the number of branches and revenue for cash and banking services, Post Office Annual Report and Accounts 2019-20: https://www.onepostoffice.co.uk/media/48554/pol-combined-ara-1920_2020-final-signed-incl-pwc.pdf

199 UK Payments Markets Report, UK Finance, (2019) https://www.ukfinance.org.uk/sites/default/files/uploads/pdf/UK-Finance-UK-Payment-Markets-Report-2019-SUMMARY.pdf

200 Based on ONS data - Bank (Standard Industrial Classification (SIC) code 64.19/1) and Building Society (SIC code 64.19/2) industries.

201 Based on LINK statistics and trends - https://www.link.co.uk/about/statistics-and-trends/

FCA[202] and assumes the trends for the change in ATMs, bank branches and Post Offices continues.

11.69 Figure 12.A shows total number of free-to-use cash facilities and operating costs for each year under the counterfactual scenario. Under this scenario the number of facilities would decrease from their current level of around 59,000 in 2022 to around 35,000 by 2032. The total cost is estimated at around £30.7 billion for the counterfactual scenario and is estimated to be £2 billion in 2032.

Figure 11.A: Scenario analysis of free-to-use cash facilities for the counterfactual

| | 2022 | 2023 | 2024 | 2025 | 2026 | 2027 | 2028 | 2029 | 2030 | 2031 | 2032 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Number of cash facilities** | 58,886 | 55,653 | 52,641 | 49,835 | 47,222 | 44,787 | 42,519 | 40,407 | 38,439 | 36,605 | 34,898 |
| **Total Cost (£bn)** | £3.8bn | £3.5bn | £3.3bn | £3.1bn | £2.9bn | £2.7bn | £2.6bn | £2.4bn | £2.3bn | £2.1bn | £2bn |

11.70 As set out above, it is not possible to determine the number of facilities that will be maintained by industry to provide reasonable levels of access, working within FCA rules. Firms may reduce overall costs through innovation and efficiency and competition in the market may mean multiple facilities are provided in areas with high demand. However, in order to provide an indication of the potential costs under the preferred policy option HM Treasury has produced the following scenario.

11.71 Under this scenario, it is assumed that a cash facility is placed every 2 square miles across 95% of the UK's landmass[203] (approximately 95,000 square miles[204]). This is equivalent to around 45,000 facilities by the end of the forecast period. The scenario assumes a constant adjustment in the number of facilities over a ten-year period to reach this number from the present level. To estimate the associated costs, the scenario retains the assumption that the number of Post Offices would remain constant, and assumes the ratio of ATMs and bank branches remains constant. This scenario does not necessarily reflect how the government may structure its policy on access to cash in a policy statement. However, it does provide a proxy for the overall

202 Number of facilities based on brick-and-mortar bank and building branches, Post Office branches (including mobile and outreach), and free-to-use ATMs. It does not include mobile bank and building society branches or cashback locations. Access to cash coverage in the UK 2021 Q3 | FCA

203 This scenario analysis has been conducted in miles to provide an illustration of the potential scale of impacts. It does not account for considerations such as population density, differences across rural or urban areas, or the distribution of facilities on a localised basis.

204 https://www.gov.uk/government/publications/toponymic-guidelines/toponymic-guidelines-for-map-and-other-editors-united-kingdom-of-great-britain-and-northern-ireland--2#fn:26

policy goal of maintaining a broad geographic spread of cash facilities across Great Britain and Northern Ireland.

11.72 Figure 12.B shows the total number of free-to-use cash facilities and operating costs for each year of the forecast. Under this scenario the number of facilities would decrease from their current level of around 59,000 in 2022 to around 45,000 in 2032 based on the assumptions above. The total cost over the forecast period is estimated at around £35.5 billion for the preferred option, and is estimated to be around £2.7 billion by 2032.

Figure 12.B: Scenario analysis of free-to-use cash facilities for the preferred option

| | 2022 | 2023 | 2024 | 2025 | 2026 | 2027 | 2028 | 2029 | 2030 | 2031 | 2032 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Number of cash facilities** | 58,886 | 57,339 | 55,833 | 54,367 | 52,939 | 51,548 | 50,194 | 48,876 | 47,592 | 46,342 | 45,125 |
| **Total Cost (£ billion)** | £3.8bn | £3.7bn | £3.5bn | £3.4bn | £3.3bn | £3.2bn | £3.1bn | £3bn | £2.9bn | 2.8bn | £2.7bn |

11.73 Comparing the impact under the scenarios presented for the counterfactual and preferred options, it is estimated that the net difference in cash facilities in 2032 would be approximately 10,000 and the additional cost would be around £700 million in that year.

*Payment of fees to the FCA*

11.74 The Bill ensures the FCA has powers to require designated relevant current account providers to pay fees to cover the FCA's costs in carrying out its functions as the lead regulator. This does not apply to the operators of designated cash coordination arrangements. It is the intention that the FCA will consult industry on the introduction of any fees. It is expected that the FCA will determine any potential fees in line with its established approach.[205]

*Possible fines*

11.75 The Bill provides the FCA with powers to supervise and enforce compliance under the legislation. This includes powers to impose penalties for non-compliance. The

205 Fees and Levies, Financial Conduct Authority - https://www.fca.org.uk/firms/fees

FCA expects to determine any potential penalty in line with its established approach.[206]

**Policy Benefits**

11.76 HM Treasury anticipates the policy will have a range of positive impacts, relative to the counterfactual. This includes: financial inclusion, for example by supporting those who may rely on cash for budgeting and managing their finances; the costs incurred to travel to access cash; costs related to the storage, handling and depositing of cash for businesses, and the associated rates of cash acceptance that enable people to transact in cash. Where possible HM Treasury has provided indicative monetary estimates for these benefits based on publicly available information.

*Access to cash and financial inclusion*

11.77 While digital payments services and innovations can offer people ways to help budget, keep a record of transactions and access financial services, cash remains an important component of financial inclusion. Although card and digital payments have become increasingly popular, evidence shows that a substantial proportion of the UK population continues to rely on cash in their day to day lives.

11.78 In 2020, cash accounted for around 17% of payments and represented the second most frequently used method of payment.[207] Despite the decline in its use, cash is still used by a majority of consumers; research by the PSR in 2019 indicated that 83% of consumers had used cash in the previous week, mostly for smaller value transactions.[208]

11.79 Cash is particularly important for vulnerable groups. The FCA Financial Lives Survey found that 42% of those aged over 85, 46% of the digitally excluded and 26% of those in poor health were reliant on cash in their day-to-day lives. Of those adults who rely on cash to a great or very great extent, one in three do so for budgeting reasons (33%) and one in four do so to avoid getting into debt (24%), while one in ten (10%) do not know how they would cope or say they would not cope at all in a cashless society.[209]

11.80 Responses to the government’s call for evidence and consultation also highlighted that cash is important as a symbol of independence, as well as an important

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206 The Decision Procedure and Penalties manual, Chapter 6, Penalties, Financial Conduct Authority, https://www.handbook.fca.org.uk/handbook/DEPP/6.pdf

207 UK Payments Report, UK Finance, (2021) https://www.ukfinance.org.uk/sites/default/files/uploads/SUMMARY-UK-Payment-Markets-2021-FINAL.pdf

208 Payments System Regulator (BritainThinks) - Access to cash research with consumers and small businesses

209 Financial Lives 2020 survey: the impact of coronavirus, Financial Conduct Authority, (2020) https://www.fca.org.uk/publication/research/financial-lives-survey-2020.pdf

budgeting tool, and is a way to help elderly or vulnerable people access social opportunities.[210]

11.81 The Bill introduces legislation that will ensure the coverage of cash facilities remains suitable for people's needs across the UK. By protecting access to cash facilities, the legislation will support the continued use of cash by those who need it to pay for essential products and services. The government expects the legislation to have a beneficial impact for those who are reliant on cash, particularly those in vulnerable groups or with protected characteristics.

*Travel Costs*

11.82 The legislation is intended to ensure that people can access cash and is thereby anticipated to help reduce the cost incurred to travel to a facility relative to the counterfactual. In addition to benefits associated with reduced travel to make a withdrawal or deposit, the cost and ease of depositing cash, along with the relative costs of accepting other forms of payments, are key factors in determining whether shops accept cash[211].

11.83 Publicly available data on the average distance a person travels to use a cash facility and how this may change over time is limited.

11.84 While data on the aggregate number of deposit transactions or associated journeys is unavailable, research commissioned by the Payment Systems Regulator in 2019 found that 75% of SME businesses surveyed that accept cash deposited cash into their bank at least monthly, while 55% did so at least weekly. With regards to the distance required to make a deposit, 45% of the respondents depositing cash reported that they travelled 1 mile to do so, 23% reported 2 to 3 miles, and 8% reported that they travelled 6 to 10 miles.

11.85 To provide an indication of the potential benefits HM Treasury has provided the following scenario-based analysis using existing published research.

11.86 As part of its work with the FCA and PSR to analyse the coverage of cash access the University of Bristol estimated that on average the population was 0.35 miles from the nearest facility.[212] To develop scenarios for the counterfactual and preferred option respectively, it is assumed that the average travel distance increases by the same proportion that the total number of facilities decreases under each of those scenarios.

11.87 Data is not available on the total number of journeys to access cash. It is therefore assumed to be equal to the annual number of transactions (including cash

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210 Access to Cash: Call for Evidence, HM Treasury, (2020) https://www.gov.uk/government/publications/access-to-cash-call-for-evidence

211 Access to Cash Call for Evidence: Summary of Responses, HM Treasury (2021) https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/997886/Access_to_Cash_-_Call_for_Evidence_-_Summary_of_Responses.pdf

212 Where to Withdraw, University of Bristol, (2020) https://www.bristol.ac.uk/media-library/sites/geography/pfrc/Where%20to%20withdraw%20-%20mapping%20access%20to%20cash%20across%20the%20UK.pdf

withdrawals and deposits by individuals and SMEs) at the Post Office[213] and ATM cash withdrawal transactions[214], adjusted annually to reflect the observed rate of decline in the number of ATM withdrawal transactions. This figure may be an underestimate of the total number of transactions and journeys to cash facilities given it does not account for journeys to other types of cash facilities.

11.88 To estimate costs under the scenarios, HM Treasury has calculated the proportion of journeys that are made to a cash facility by private and public modes of transport[215], and assumed a travel cost of 45p per mile for private modes[216] of transport excluding walking and cycling.

11.89 In practice, a proportion of the population may also travel to access cash by public transport. According to the National Travel Survey around 3% of journeys are made by bus and 6% of journeys are made by public transport.[217] As a representation of the possible cost of such journeys, the average single bus fare is reported as £2.48.[218] As a result, the analysis presented is likely to be an underestimate of the journeys that incur a travel cost.

11.90 Based on the scenarios for the number of cash facilities presented in figure 1 and 2, Figure 11.C shows the average distance a person travels to a cash facility and the cost of travel for the scenarios relating to the counterfactual and preferred option. HM Treasury estimates that the relative savings in travel costs due to the legislation at approximately £23 million in 2032 and £152 million over the forecast period.

Figure 11.C: Scenario analysis for the total cost of travel to a cash facility

| | 2022 | 2023 | 2024 | 2025 | 2026 | 2027 | 2028 | 2029 | 2030 | 2031 | 2032 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Counterfactual | | | | | | | | | |
| Average travel distance (miles) | 0.35 | 0.37 | 0.39 | 0.41 | 0.43 | 0.46 | 0.48 | 0.50 | 0.53 | 0.55 | 0.58 |
| Cost (£ million) | 372 | 352 | 333 | 315 | 298 | 282 | 267 | 253 | 240 | 227 | 215 |
| | | Preferred option | | | | | | | | | |

213 Post Office, (2020) - https://www.onepostoffice.co.uk/secure/latest-news/our-business/banking-agreement-to-continue-for-three-more-years

214 Statistics and trends, LINK, (2022) https://www.link.co.uk/about/statistics-and-trends/

215 ONTS0308: Average number of trips by trip length and main mode: England: https://www.gov.uk/government/statistical-data-sets/nts03-modal-comparisons

216 Based on HMRC tax relief for work vehicles https://www.gov.uk/tax-relief-for-employees/vehicles-you-use-for-work

217 Average proportion of journeys at all distances by public transport. Calculated using data from Department for Transport - National Travel Survey 2020 https://www.gov.uk/government/statistics/national-travel-survey-2020/national-travel-survey-2020

218 6th TAS National Bus Fares Survey: 2019 https://taspartnership.co.uk/wp-content/uploads/2018/02/30281-REP-TAS-National-Fares-Survey-2019.pdf

| Average travel distance (miles) | 0.35 | 0.36 | 0.37 | 0.38 | 0.39 | 0.40 | 0.41 | 0.42 | 0.43 | 0.44 | 0.45 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Cost (£ million) | 372 | 348 | 326 | 305 | 285 | 267 | 250 | 234 | 219 | 205 | 192 |

*Customer Experience of Accessing Cash*

11.91 The legislation is intended to ensure there is reasonable provision of cash facilities across the UK. As a consequence of the legislation, both individuals and businesses may benefit from a better experience when using cash facilities relative to the counterfactual. For example, a broader provision of facilities may help to mitigate against increases in queuing time to use a facility. Research commissioned by the PSR found respondents reported concerns over longer queuing times as a result of a lower provision of cash facilities.[219] Furthermore, research commissioned by the FCA found that SMEs associated changes in time for depositing cash to an increase in queuing times and reduced opening times.[220]

*Cash Acceptance*

11.92 HM Treasury anticipates that the legislation will support businesses to continue accepting cash as a method of payment. HM Treasury therefore expects that the legislation may reduce the potential number of incomplete cash transactions (where a consumer's attempt to make a payment in cash is declined and the consumer makes no purchase) in relative terms compared to the counterfactual.

11.93 It remains the choice of individual retailers as to which payment methods they offer their customers, including cash, cards, and digital payments. Research by the FCA identified that the primary driver for accepting cash was customer preference, and that 98% of small and medium enterprises surveyed would never turn away a person who needed to pay in cash.

11.94 To provide an indication of the potential benefits in relation to cash acceptance, HM Treasury has provided scenario-based analysis using existing published research. This should not be interpreted as a forecast of what HM Treasury thinks *will* happen, but rather an exploration of what *could* happen.

11.95 Research commissioned by the PSR[221] found, in 2019, that 9% of UK adults reported they had one cash payment refused by a business in the previous month. Of these individuals, 11% did not go on to make any purchase, meaning the transaction was

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219 Payments System Regulator (BritainThinks) - Access to cash research with consumers and small businesses https://www.psr.org.uk/media/qnslp3ma/psr-access-to-cash-full-report-july-2019.pdf

220 https://www.fca.org.uk/publication/research/cash-acceptance-within-smes.pdf

221 Payments System Regulator (BritainThinks) - Access to cash research with consumers and small businesses https://www.psr.org.uk/media/qnslp3ma/psr-access-to-cash-full-report-july-2019.pdf

lost, though data is not available on whether such lost transactions may have been displaced to other retailers for example. It is assumed that the same trend occurred across the UK population[222] in each month to produce an annual estimate for the scenarios.

11.96 For the scenario under the preferred policy option HM Treasury has assumed that the percentage of the population that has a cash payment declined remains constant. For the counterfactual, HM Treasury has assumed the percentage of lost transactions increases proportionately to the decrease in the number of cash facilities. In practice, these assumptions may be affected by people transitioning to alternative payment methods.

11.97 To estimate the value of cash transactions that may be lost, it is assumed that the average value of a cash transaction continues to increase in line with existing trends.[223]

11.98 Figure 12.D shows the volume and value of lost cash transactions for the scenarios under the counterfactual and preferred option. Under the preferred option there would be 5.1 million fewer incomplete cash transactions by 2032, estimated to be a benefit of around £154 million. Across a ten-year period there would be 26 million fewer incomplete cash transactions at a value of around £651 million. This is a benefit to businesses as the legislation is designed to ensure reasonable access to deposit facilities, thereby reducing the potential for lost revenue as a result of being unable to accept cash payments.

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222 Office for National Statistics https://www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/populationestimates/articles/overviewoftheukpopulation/january2021

223 Data on average value of a cash transaction: British Retail Consortium – Payments Survey 2021 https://brc.org.uk/media/678339/payments-survey-2021.pdf

Figure 12.D: Scenario analysis for the value of potential lost cash transactions

| | 2022 | 2023 | 2024 | 2025 | 2026 | 2027 | 2028 | 2029 | 2030 | 2031 | 2032 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Counterfactual | | | | | | | | | | |
| **Number of lost cash transactions (million)** | 7.9 | 8.3 | 8.8 | 9.2 | 9.7 | 10.2 | 10.7 | 11.2 | 11.8 | 12.4 | 13 |
| **Value of lost cash transactions (£ million)** | 118 | 133 | 150 | 169 | 191 | 216 | 243 | 274 | 310 | 349 | 394 |
| | **Preferred option** | | | | | | | | | | |
| **Number of lost cash transactions (million)** | 7.9 | 7.9 | 7.9 | 7.9 | 7.9 | 7.9 | 7.9 | 7.9 | 7.9 | 7.9 | 7.9 |
| **Value of lost cash transactions (£ million)** | 118 | 127 | 136 | 146 | 157 | 168 | 181 | 194 | 208 | 223 | 240 |

*Storage and Handling Costs*

11.99 The legislation will support businesses to obtain reasonable access to cash deposit facilities within a reasonable distance. This may support businesses in relation to increasing cost-efficiency associated with the storage and handling of cash on premises.

11.100 The British Retail Consortium (BRC) conducts research on the expenditure that retailers incur for accepting payments, taking account of the various cost factors including bank charges, transit costs, cash handling charges, and write offs (losses). It finds that the average cost of a cash transaction to its survey respondents is 2.44p. The BRC also finds, measured by pence per transaction, cash remains the most cost-effective payment acceptance channel for retailers[224].

11.101 By ensuring access to deposit facilities HM Treasury anticipates the legislation may result in benefits relating to lower storage and security costs associated with holding lower amounts of cash on premises.

**Wider Benefits**

11.102 There may also be additional benefits relating to customers' ability to access cash that it has not been possible to quantify. As a result, the quantified benefits presented may be underestimates of the impacts.

224 Payments Survey 2021, British Retail Consortium, (2021) https://brc.org.uk/media/678339/payments-survey-2021.pdf

11.103 The government's Call for Evidence on Cash and Digital Payments[225] found that cash is important as a symbol of independence, as well as an important budgeting tool, and is a way to help elderly or vulnerable people access social opportunities. This is supported by research commissioned by the PSR[226], which found that older people are more likely to prefer cash, potentially linked to digital inclusion and access to digital devices. This research also found that individuals with long term health conditions were more likely to prefer cash than those without.

11.104 Research commissioned by the FCA found that some consumers may experience poor mental health outcomes including stress and anxiety if they were to struggle to access essential goods using cash over the longer term.[227]

11.105 Analysis from the Where to Withdraw Report by the University of Bristol, in collaboration with the FCA and PSR, suggests that relative to the population, more deprived and urban neighbourhoods are associated with higher total numbers of cash withdrawals. The report indicates that in the UK the most deprived decile saw a 19% decline in the provision of free-to-use ATMs, though as noted above the number of cash access points in itself does not provide a complete picture of supply. There are therefore potential socio-economic benefits to protecting access to cash.

**Assumptions, limitations, and considerations**

11.106 As noted throughout the analysis, where HM Treasury has provided indicative monetary estimates for costs and benefits these have been made using publicly available information. Where HM Treasury has provided scenario-based analysis it has been assumed that existing trends, where known, will continue into future years. However, owing to the range of factors that may affect the analysis and the assumptions that have been used, this analysis should not be interpreted as what HM Treasury thinks the monetary impacts will be, but rather an exploration of what they could be for this measure.

**Small and MicroBusiness Assessment (SaMBA)**

Number and distribution of businesses in scope of the regulation

11.107 The Bill provides the FCA with monitoring, supervision and enforcement powers to regulate the provision of cash facilities. Banks and building societies that are designated by HM Treasury following the Royal Assent of the Bill would be within scope of these powers. These powers also apply to the operator of any cash coordination arrangements that are to be designated by HM Treasury. Organisations

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225 Cash and digital payments in the new economy: summary of responses, HM Treasury, 2019: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/799548/CfE_-_Cash___Digital_Payments_Response_020519_vf_digicomms.pdf

226 Payments System Regulator (BritainThinks) - Access to cash research with consumers and small businesses https://www.psr.org.uk/media/qnslp3ma/psr-access-to-cash-full-report-july-2019.pdf

227 Financial Conduct Authority – Understanding cash reliance: qualitative research (July 2021) https://www.fca.org.uk/publication/research/understanding-cash-reliance-qualitative-research.pdf

that are involved in the provision of cash facilities but are not designated by HM Treasury will be subject to FCA powers relating to obtaining information only.

11.108 HM Treasury has provided an indicative assessment of the number and distribution of businesses in scope based on publicly available data. The department is unable to specify the number of firms in scope of this measure. This is because decisions on the designation of individual firms under this measure and the details of the FCA's approach to regulation have not been taken at this stage.

11.109 HM Treasury anticipates that none of the banks or building societies to be designated would meet the definition of small or micro businesses – for the purpose of this analysis, to provide an indication of scale this is considered to be firms with less than 50 employees or turnover of less than £10 million per year. The Bank publishes a list of the banks and building societies that are regulated by the Prudential Regulation Authority. As of 1 August 2022, there were 159 banks and 43 building societies incorporated in the United Kingdom in total.[228] Analysis published by the Office for National Statistics for 2018 shows the count, employment, employees and turnover (£'000s) of VAT and/or PAYE based enterprises in the United Kingdom for banks and building societies (UK Standard Industrial Classification 2007 sub classes 64.19/1 and 64.19/2).[229] The banks included had 1,411 employees on average and building societies had 104 employees on average. Furthermore, on average, the banks had turnover of £1.9 billion and building societies had turnover of around £28 million in 2018. The Bill requires HM Treasury to consider the following factors for designation decisions: a firm's geographic coverage; distribution of customers; and market share. HM Treasury has stated publicly via its consultation process and supporting products for the Bill that it only intends to designate larger banks and building societies on the basis of these criteria.

11.110 The Bill also enables HM Treasury to designate operators of cash access coordination arrangements provided that at least one of the participants in the arrangements is a designated bank or building society. No decisions have been taken with regards to the designation of specific operators of cash coordination arrangements at this time. To provide an indication of potential scale for the purpose of this assessment - in December 2021, major retail banks announced a voluntary industry model for the provision of cash access facilities, including initiatives to provide shared services. Under the model, LINK would assess the cash needs of local communities with a view to ensuring appropriate cash services are in place. As of 2021, LINK reported employment of 50 full time equivalents and turnover of £13 million. As a result, there is no evidence at present that this category would include SMBs. While it may be possible for this category to include SMBs as a result of a future designation, firms are able to take their own commercial decision as to whether to take on a cash coordination function, and only those that do have a cash coordination function will be capable of being designated in this way.

228 https://www.bankofengland.co.uk/prudential-regulation/authorisations/which-firms-does-the-pra-regulate

229 Banks and building societies count, employment and turnover, ONS, 2019

11.111 Furthermore, the Bill provides the FCA with powers over persons who are not designated but may have relevant information to support the FCA in exercising its functions under the measure – these powers are limited to obtaining information only. It is not possible to determine the total number or distribution of firms that may be impacted by these powers as this is subject to the FCA's regulatory approach. Beyond the designated firms referenced above, the type of firms within scope may consist of a bank or building society; operator of a cash coordination arrangement; the operator of, or an infrastructure provider in relation to, a payment system; a person who provides cash withdrawal or deposit facilities; or a person who provides a relevant service to those persons. The number of firms that the government expects to be in scope of these powers is low, and many are medium or large size businesses. As context for the number of scale and size of the firms that may fall into such categories, examples may include, but are not limited to, the following:

11.112 The Payment Systems Regulator oversees 7 payment systems and one service provide that have been designated by HM Treasury under the Financial Services (Banking Reform) Act 2013.[230] Those designation decisions were based on consideration of factors including the number and value of transactions processes set out in that Act, which helps to ensure proportionality. Not all of these payments systems are involved in the provision of cash.

11.113 The LINK ATM network is a payment system overseen by the Payment Systems Regulator that is involved in the provision of cash facilities. It lists 33 members on its website, which may include small or micro-businesses.[231] Members includes firms acting as card issuers (predominantly banks and building societies – see above for information on this type of business), ATM deployers (firms that provide or operate ATMs), or firms undertaking both of these roles. LINK lists 9 members as ATM deployers only.

11.114 Providers of cash withdrawal or deposit facilities includes the Post Office, which provides everyday banking services including cash withdrawal and deposit services on behalf of 30 banks, building societies and credit unions, had revenue of £957 million in 2021.[232] It is not considered a SMB in this assessment.

Do the impacts fall disproportionately on small and microbusinesses?

11.115 It is not expected that small and micro-businesses in financial services would be disproportionately affected by this measure. As set out above, the firms expected to be designated under this measure are not expected to include small or micro-businesses. When information powers are also considered, the government believes any impact on small or micro-businesses is proportionate and likely to be targeted to a very small number of firms.

230 Who we regulate, Payment Systems Regulator, 2022

231 LINK, Members, 2022

232 Annual Report and Accounts, Post Office Limited, 2021

11.116 The FCA will only have the ability to collect fees in relation to the carrying out of the FCA's functions in relation to this measure, from banks and building societies that are designated by HM Treasury - as set out above HM Treasury has stated publicly via its consultation process and supporting products for the Bill that it only intends to designate larger banks and building societies on the basis of the criteria in the legislation. As a result, the ability to collect fees would not extend to cash coordination arrangements that may be designated or any firms within scope of powers for the FCA to collect information only – at present, there is no evidence that this would include small or micro-businesses, but this would help to ensure that such any such business was not disproportionately affected.

11.117 It is not possible to determine costs relating to regulatory compliance, such as providing information requests, against the distribution of businesses in scope. For example, a range of firms already FCA already provide information to the FCA on the location and characteristics of cash access points[233] – complying with such information requests may have a fixed cost element associated with them, for example in terms of resourcing, but may also vary according to the business. A firm reporting on a greater number of facilities may have a higher compliance cost in total, but this may also be subject to the monitoring systems that it already has in place and so costs may be incremental or negligible. According to data published by LINK, as of 2021, the ATM deployer with fewest ATMs connected to the network had 3 ATMs, while the ATM deployer with most ATMs had 16,048.[234]

11.118 HM Treasury anticipates that many of the firms that are within scope of the legislation are likely to already be subject to existing financial services legislation, for example because they are an operator, member, or service provider to a payment system. As a result they are expected to be familiar with regulatory compliance thus reducing the costs associated with the legislation.

11.119 Furthermore, the legislation applies the FCA's existing regulatory principles. This includes the principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction.

Could small and microbusinesses be exempted while achieving the policy objectives?

11.120 As set out above, the government has designed the legislation such that the firms anticipated to be designated under this measure are not expected to include SMBs. The government believes any impact on SMBs, for example in relation to information gathering, is proportionate and likely to be targeted to a very small number of firms.

11.121 If SMBs were exempted from this measure, then this would risk compromising the ability of HM Treasury and FCA to fulfil their functions under the legislation. For example, the FCA may be unable to collect information about the location and

233 Access to cash coverage in the UK 2021 Q4, FCA, 2022

234 LINK / Statistics and trends

characteristics of cash withdrawal and deposit facilities. As a result, it would be unable to assess whether there is reasonable access in order to determine whether to take regulatory action, or provide reports to HM Treasury to inform any policy statement issued under the legislation.

11.122 HM Treasury sets out mitigations in the legislation below, and does not consider it appropriate to provide specific exemptions for small and micro-businesses.

Could the impact on small and microbusinesses be mitigated while achieving the policy objectives?

11.123 As set out above, the government has designed the legislation such that the firms anticipated to be designated under this measure are not expected to include small or micro-businesses. The government believes any impact on SMBs, for example in relation to information gathering, is proportionate and likely to be targeted to a very small number of firms.

11.124 The legislation is already designed in such a way that helps to ensure that small and micro-business are not disproportionately affected - for example, the ability of the FCA to collect fees only applies to designated banks and building societies, which the Government has publicly indicated are expected to be larger businesses in line with the criteria set out in legislation.

11.125 The legislation does not enact requirements on firms directly. It enables the FCA to exercise powers against firms. With regards to regulatory action taken under this measure - it is the responsibility of the FCA to ensure their regulatory action is proportionate and determine whether further mitigations are appropriate when considering regulatory intervention.

11.126 HM Treasury does not, therefore, consider it appropriate to provide further specific mitigations for SMBs under this measure.

Wider impacts on small and microbusinesses

11.127 HM Treasury expects that the wider impacts of this measure will benefit many small and micro-businesses.

11.128 The legislation will support SMBs to access suitable cash deposit facilities. As noted above, HM Treasury anticipates this may support businesses, for example in relation to lower handling and security costs associated with holding lower amounts of cash on premises, travel costs for depositing cash, and enable businesses to continue accepting cash from customers.

11.129 Research commissioned by the PSR in 2019 found that over half of the small businesses surveyed (54%) accepted cash, rising to 91% for accommodation and food services, with the lowest sector reported as professional services (34%).[235] Of the businesses reporting as accepting cash, three quarters (75%) had deposited cash in the bank at least monthly – this was higher than the proportion of respondents

235 Access to cash full report, PSR, July 2019

reporting that they had used cash they had accepted in order to maintain a float (34%) or to pay suppliers (22%).

11.130 A survey commissioned by the FCA found that 98% of small businesses surveyed would never turn a customer away if they needed to pay in cash, while almost 8 in 10 say they are ‘very likely’ to accept cash over the next 5 years.[236] Cash can also be recycled through these businesses, for example if they pay suppliers and employees in cash, or it is taken as personal wages.

[236] Cash acceptance within SMEs research, FCA, 2021

## Access to Cash (Wholesale Cash Distribution)

**Problem under consideration**

The Wholesale Cash Network

12.1 The cash lifecycle begins with banknote and coin production. A third-party contractor prints Bank of England (Bank) banknotes[237], which are then issued by the Bank. Commercial banks in Scotland and Northern Ireland (S&NI) are authorised to issue S&NI banknotes[238]. The Royal Mint (Mint) produces and issues new coins on behalf of HM Treasury.

12.2 The major parts of the UK's cash infrastructure are the retail cash network and the wholesale cash network. The retail cash network is the UK's network of facilities such as banks, Post Office branches, and ATMs that receive banknotes and coins (cash) distributed by the wholesale cash network. The retail network is public-facing and enables consumers to access this cash. The Bill also introduces legislation regarding oversight of the retail cash network (see Chapter 11 of this Impact Assessment).

12.3 To support continued access to cash, the UK needs a sustainable and resilient wholesale cash system. This is the infrastructure, including a system of cash centres, that is integral to the sorting, storing and distribution of coins and notes. The wholesale cash network sits between the entities responsible for issuing cash, and the retail cash network. This measure relates to the wholesale cash network.

12.4 The wholesale cash network comprises multiple participants, including the Bank, S&NI banks, the Mint, the Post Office, commercial banks, cash centres, cash in transit ("CiT") providers and other goods and services providers.

12.5 The Bank and HM Treasury, as the issuing authorities of cash, are responsible for withdrawing cash once it is no longer fit for purpose. However, the wholesale recirculation and distribution of those banknotes and coins during their lifetime occurs in the wholesale cash supply chain, which is predominantly within the private sector, although the Post Office is a wholly state-owned entity.

The Note Circulation Scheme

12.6 To ensure effective distribution of Bank of England banknotes around the UK, the Notes Circulation Scheme (NCS) governs the distribution, processing and storage of Bank banknotes. It provides a framework for the wholesale commercial cash industry which helps encourage efficiencies in their banknote operations. Legal agreements and rules underpin how the NCS operates. This allows its members[239] to hold

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237 These are the most common form of banknote, and predominantly used in England.

238 Three banks are authorised to issue banknotes in Scotland (Bank of Scotland plc, Clydesdale Bank plc, and The Royal Bank of Scotland plc), and three banks are authorised to issue banknotes in Northern Ireland (Bank of Ireland [UK] plc, AIB Group [UK] plc, Northern Bank Limited, and National Westminster Bank plc). AIB Group (UK) plc used to issue banknotes in Northern Ireland but ceased issuance on 30 June 2020.

239 G4S Cash Solutions (financially underwritten by Lloyds and Santander), Post Office, National Westminster Bank, and Vaultex UK (a joint venture between HSBC and Barclays).

banknotes in custody on behalf of the Bank, within their cash centres. While the NCS does not govern coin or S&NI banknotes, it provides a framework for the wholesale cash industry which helps encourage efficiencies across their operations. The NCS members and their financial backing institutions are also the key industry participants for wholesale cash operations for coin and S&NI banknotes. Legal agreements between the Bank and NCS members underpin the NCS and require NCS members to abide by the rules and provisions set out in the NCS rulebook.

12.7 The NCS members purchase banknotes from the Bank, and they are, in turn, purchased by their customers. These include ATM operators; financial institutions; retailers and other businesses. NCS members purchase banknotes from the issuers at face value and then sell these on to their customers. They also charge their customers (e.g. shops) for collecting and sorting the cash. Similar arrangements apply to coin and S&NI banknotes.

12.8 As of February 2022, there were a total of 17 NCS-registered cash centres active in the UK; nine of these sites process banknotes and coin, while eight are banknote only centres. Additional cash centres are currently operating, but only process coin and/or S&NI banknotes, and/or are non-NCS cash centres, however the Bank and HM Treasury do not hold data on these sites.

12.9 Once Bank of England banknotes are sold to the NCS members, they are then in circulation and are free to move around the retail cash infrastructure and on to the public. There is also some local cash recycling, whereby cash moves around different retail cash infrastructure and the public. When the retail cash network's public facing services wish to deposit Bank of England banknotes, the vast majority are sold back to the NCS members for processing at an NCS cash centre, although limited local recycling[240] of banknotes does occur at some retailers. Once the cash is returned to the NCS member, the banknotes are checked for authenticity and monitored for quality, with suspect or unfit banknotes sent back to the Bank and fit banknotes allowed to go back into circulation. Similar but distinct arrangements apply to coin and S&NI banknotes.

Scottish and Northern Irish Banknote issuers

12.10 In Scotland and Northern Ireland, commercial banknote issuers authorised by the Bank contract commercial printers to produce new banknotes to meet demand. S&NI banknotes are issued into circulation from cash centres in Edinburgh, Glasgow, and Belfast to meet direct demand through the issuer's branches and through ATM networks.

12.11 As with the NCS, S&NI banknotes are also bought directly by cash centre operators within the region and circulated in a similar manner to Bank of England banknotes. There are some cash centres that exclusively process S&NI banknotes. However, HM Treasury and the Bank do not hold data on these cash centres as they are outside of the scope of the NCS.

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[240] The practice of using lower speed, lower volume banknote sorters at or near the point of circulation in a de-centralised model, usually with the aim of decreasing CiT costs.

Coin distribution

12.12 Coins are issued by the Mint on behalf of HM Treasury (the issuing authority), and then circulated to the cash centres which process coin to be distributed through the UK. There are some cash centres that exclusively process coin. HM Treasury and the Bank do not hold data on these cash centres as they are outside of the scope of the NCS.

**Rationale for intervention**

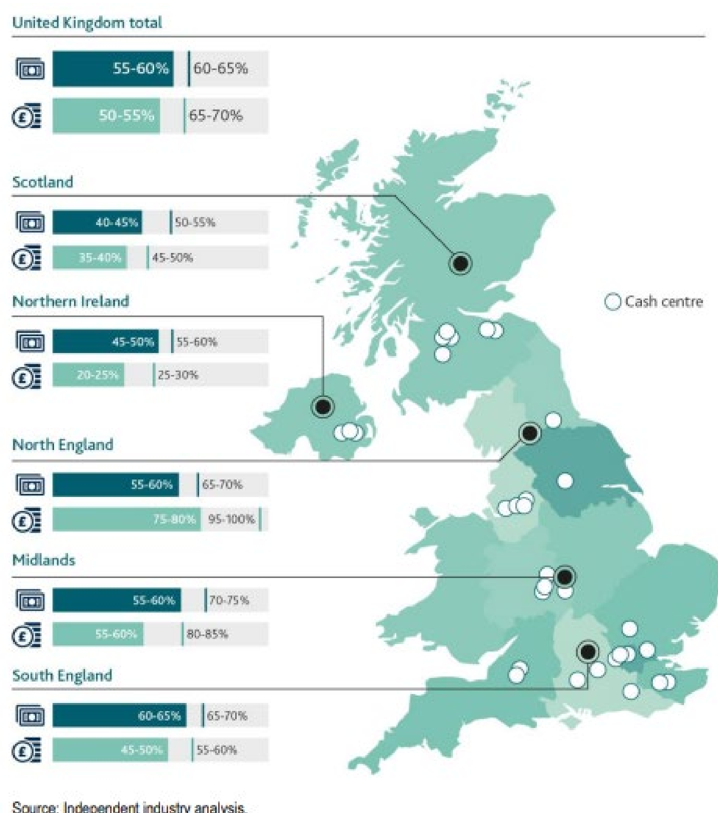
12.13 There has been a transition away from cash towards card payments and other digital payment methods. As the number of cash transactions in the UK has declined, wholesale cash processing activity has also declined, and utilisation of cash centre capacity has fallen. Many of the costs throughout the wholesale cash network are fixed. According to independent analysis commissioned by the wholesale cash industry, in 2018 around two-thirds of costs incurred by the wholesale cash network were fixed costs and a third were variable costs. With high fixed costs and lower utilisation there is pressure on the unit costs of cash processing.

12.14 In 2018, average utilisation across cash centres was 55-60% for banknotes and 60-65% for coins. Anecdotal evidence from NCS members has indicated a further decline since.[241]

12.15 For both banknotes and coins, there is significant regional variation in cash centre utilisation across the UK, as can be seen from Figure 13.A. In 2018 for banknotes capacity utilisation varied from 60-65% in the South of England to 40-45% in Scotland and for coins it varies from 75-80% in North England to 20-25% in Northern Ireland.

[241] Consultation on the Future of the UK's Wholesale Cash Distribution Model (bankofengland.co.uk)

Figure 12.A: UK cash centre utilisation in 2018[242]




Source: Independent industry analysis.

Note: Figures on the right represent the peak utilisation rates. The peak utilisation reflects the annualised volumes by region for the peak week in that region, as a % of the regional processing capacity. Utilisation is calculated as notes processed as a proportion of the throughput of the high and medium speed note sorting machines available within the cash centre network. Coin utilisation is calculated as coins processed as a proportion of the throughput of the bullion and check-weight machines available within the cash centre network.

12.16 These rising industry costs could be passed on to retailers and others, leading to a rise in the cost of handling cash, affecting the willingness of business to accept it as a form of payment. This would have an adverse impact on cash intensive businesses, small retailers, and frequent cash users which include elderly and vulnerable groups.

12.17 Furthermore, rising costs and excess capacity have created commercial pressures for rationalisation (closures within individual wholesale networks and operations) of the existing infrastructure and/or consolidation (mergers and acquisitions between individual wholesale networks and operations) of the wholesale cash network participants. If a restructuring were to happen in a disorderly way it could pose a potentially significant risk to the wholesale cash infrastructure's effectiveness and sustainability, and consequently its ability to supply cash as and when required to the retail network across the UK. This could result in some UK regions having insufficient wholesale cash coverage, which could increase the cost of cash to businesses and reduce the industry's ability to cope with unexpected or significant changes in cash processing and distribution requirements.

12.18 In response, the Bank convened the wholesale cash industry in May 2019 under the Wholesale Distribution Steering Group (WDSG). The WDSG was set up to design a

242 Consultation on the Future of the UK's Wholesale Cash Distribution Model (bankofengland.co.uk)

new, industry-led model for wholesale cash in the UK (the utility) through a coordinated, orderly process.

12.19 WDSG worked to design an effective, efficient, sustainable, and resilient new model for wholesale distribution of cash in the UK, including investigating the option of moving to a single 'utility' structure. Ultimately, industry did not reach consensus to move to a utility model. However, WDSG members have agreed on the challenges and risks to the industry and made industry wide commitments to ensure its continued effectiveness and resilience, and to enable the wholesale cash infrastructure to continue to support the effective provision of cash.

12.20 The government expects the industry will still transition to a smaller overall network in the coming years. However, this will be without an agreed transition plan or an agreed end-state model. This transition could be through rationalisation of the existing networks, or consolidation of the number of networks and operators. If this restructuring happens in a disorderly way it could pose a potentially significant risk to the wholesale cash infrastructure's effectiveness and sustainability, and consequently its ability to supply cash as and when required to the retail network across the UK. These risks need to be managed and it is the government's view that it is not possible to do that through voluntary arrangements alone.

12.21 Rationalisation and/or consolidation will likely concentrate the market over time, potentially creating a systemic entity(ies). This is where the importance of an entity in the market is such that its failure would lead to significant disruption across the entire cash infrastructure. Given cash's status as a contingency method of payment in the event of disruption to other payment methods, this creates risks to financial stability and confidence in the UK financial system.

**Policy Objective**

12.22 The objective is to provide the Bank with powers to oversee entities involved in the wholesale cash system to ensure that it remains effective, resilient and sustainable in the long-term.

12.23 This will aim to ensure that a sustainable model for wholesale cash can support wider access to cash and the provision of the retail cash infrastructure, by seeking to ensure that the risk of disruption to significant market participants is managed.

12.24 It also seeks to manage any risks to financial stability and risks to confidence in the UK financial system that could arise through the creation of a systemic entity in the wholesale cash network.

12.25 The policy intention is not to dictate commercial outcomes in the industry, or to bind organisations into the wholesale cash market. The intention is to ensure that any transitions are managed in an orderly fashion. This will reduce the risk of market failure arising from a consolidated industry where one market participant has significant market power.

**Description of Options Considered**

12.26 Option 0 (Do nothing) - In this scenario the Bank would not have the levers that it requires to oversee the wholesale cash network and manage the risks to the policy objective. The Bank's existing levers are the NCS, and the voluntary commitments to cash made by the wholesale cash industry. The levers available under the NCS are limited. The NCS is primarily focused on incentivising proper and efficient handling of banknotes, from authentication and quality standards, to banknote withdrawal, storage and issuance requirements, rather than the effectiveness, resilience, and sustainability of the wholesale cash network, and financial stability. Ultimately, the only existing lever held by the Bank under this approach would be withdrawing membership of the NCS and its associated benefits. However, this could precipitate an industry participant exiting the market in a disorderly manner and therefore, be counterproductive to meeting the policy objectives. Furthermore, the existing commitments to cash made by the wholesale cash industry are voluntary and the Bank does not have any powers to enforce these. In the event of a significant disruption, or the risk thereof, to cash supply, there would be no regime in place to manage these risks or gather the required information to pre-empt these risks on an industry-wide basis.

12.27 Option 1 (Preferred Option) - Bank Oversight Regime: To introduce a two-level oversight regime for the wholesale cash network.

a. The first level is market oversight. This is to provide the Bank with powers to oversee entities involved in the wholesale cash network. This would include powers on information gathering, for the purpose of allowing the Bank to form an aggregate picture of the overall health of the network and identify emerging risks. Provisions would also be made for issuance of codes of practice to set standards that regulated entities must meet and the powers of directions, requiring, prohibiting or adjusting the taking of actions. Other regulatory powers would be provided to the Bank, including enabling the Bank to publish statements of principles for the industry to follow. This would be alongside reporting powers, powers of inspection, enforcement, the levying of fees for the operation of the scheme and to enforce penalties for non-compliance. The Bank would seek to use these powers to manage risks to the effectiveness, sustainability, and resilience of the wholesale cash network.

b. The second level is prudential regulation. This would apply where an entity was deemed to be systemic and not already subject to sufficient alternative prudential regulation. The Bank would exercise powers that are largely similar to the market oversight level. However, under prudential regulation the Bank would exercise these powers for the purposes of financial stability, and the resilience of any systemic entity within scope.

12.28 Option 2 (Non-preferred) - Update the Note Circulation Scheme (NCS). HM Treasury could encourage the Bank to work with industry to update the NCS to meet the overarching policy objectives. Terms within the NCS could be updated to require more sustainable practices from industry. However, the NCS is ultimately a voluntary commercial agreement, and it would be difficult to encourage the operators to agree to terms that are not commercially advantageous. Furthermore, relying solely on a

commercial contractual agreement would limit the ability to implement enforcement mechanisms to underpin the Bank's powers, as the signatories would need to agree to any terms included within the NCS. Also, the financial backing institutions that underwrite and outsource their operations to NCS signatories, are not signatories to the NCS rulebook and would, therefore, be out of scope and could not be engaged using this approach despite being significant participants in the wholesale cash network. The NCS only covers banknotes, and so could not be used to meet the policy objectives for cash overall.

**Outline of preferred policy**

12.29 This regime is intended to enable the Bank to manage any disorderly transitions as the wholesale cash network seeks to rationalise and consolidate. This will seek to mitigate the risks to the effectiveness, sustainability, and resilience of the wholesale cash network. This regime would also seek to manage the risks to financial stability raised by the formation of a systemic entity, by giving the Bank the powers to oversee and direct mitigating action for any risks of significant disruption or failure in this entity. This seeks to ensure that the infrastructure is sustainable and can support the public's continued access to cash into the future.

12.30 The Bill provides powers for HM Treasury to designate organisations as within scope of this regime. The regime puts entities in scope of market oversight and in addition prudential oversight if they are sufficiently systemic.

a. Market Oversight: Statutory powers for the Bank to oversee the wholesale cash distribution market activities of significant participants in the wholesale cash network, to manage risks to the sustainability, resilience, and effectiveness of the wholesale cash network.

b. Prudential Oversight: Statutory powers for the Bank to prudentially regulate an entity that is assessed to be a systemic risk to financial stability and is not already subject to adequate prudential oversight. Through this the Bank will seek to manage risks to financial stability and confidence in the financial system.

12.31 The powers that will be provided to the Bank are set out in further detail below.

12.32 The Bank would use these powers at their discretion, but they must only be used to manage risks to the effectiveness, resilience, and sustainability of the wholesale cash network, and risks to financial stability.

12.33 The Bank will engage with the industry and HM Treasury on its approach to regulation under the regime. It will publish a statement before it is able to exercise any of the powers in this regime over designated entities. The statement will outline how the Bank intends to use its powers.

Powers

*Principles*

12.34 The Bank will have powers to issue high-level principles for designated entities to follow.

12.35 For market oversight, the principles will relate to ensuring effectiveness, resilience, and sustainability in the wholesale cash market infrastructure. The key participants in the wholesale cash network have already made high-level commitments to the system, and it is expected these principles will seek to codify these commitments.

12.36 For the prudential oversight regime, the Bank envisage that they would apply their existing Principles for Financial Market Infrastructures (PFMIs), as appropriate.

12.37 The Bank will engage with entities that are within scope when creating principles that it intends to issue. This would apply in both the market oversight, and prudential oversight regimes.

*Codes of Practice*

12.38 The Bank will have the power to publish codes of practice for designated entities. Different codes of practice will apply to different areas, for both the market oversight and prudential oversight regimes. It is envisaged that these codes could apply to the following areas:

a. Business plans.

b. Governance arrangements.

c. Relevant aspects of contractual relationships between operators and their backing financial institutions.

d. Capital requirements and financial resilience (systemic entities only).

e. Risk management (systemic entities only).

12.39 The Bank will engage with designated entities when creating codes of practice.

*Power to require information*

12.40 Information gathering is expected to form the core part of this regime. The Bank already engages the key industry participants in a voluntary process of information sharing. The intention is for the Bank to build on these existing processes, and ensure they are required to be followed by all participants.

12.41 The purpose of information gathering is to allow the Bank to form an aggregate picture of the overall capacity and health of the wholesale cash distribution industry and identify emerging risks. The Bank will require information in the pursuit of its supervisory activities, and may require information to help HM Treasury determine whether to designate an entity.

12.42 Designated entities can be required to inform the Bank if certain events occur, such as if there are material changes to their operations that could impact on the purpose of this regime.

*Directions*

12.43 The Bank will have powers to give directions to designated entities, requiring, or prohibiting the taking of specific actions or to set standards that the entity must meet.

12.44 Directions will not seek to stop commercial solutions to the challenges faced by the network. For example, if a designated entity sought to close a cash centre, the Bank may direct them to ensure that the resultant capacity reduction in the market could be managed. In line with its broader approach to regulatory oversight, the Bank will seek to use this power proportionately and as required. Further details on how the Bank intends to use this power would be set out in its regulatory approach policy statement.

12.45 Through the Bank's existing close engagement with the industry, many industry members already engage and seek guidance from the Bank on managing significant changes to the network. In doing so, the Bank seeks to provide guidance and works with industry to mitigate any risks that arise. Through this regime, the government is seeking to codify this best practice in statute and ensure it is consistently followed.

12.46 Where a direction is given to a designated entity under the prudential oversight regime for the purpose of resolving or reducing a threat to the stability of the UK financial system, the entity (including its officers and staff) will be immune from liability for damages when acting in accordance with a direction. This is to ensure that any designated entities can fully engage with directions that are given, without concern that they may be held responsible for any unintended consequences. This is important where the Bank may need to act swiftly in relation to matters threatening the stability of the UK financial system and requires designated entities to do the same. As with its other powers under the regime, the Bank will seek to issue directions in a manner that is proportional to the risks and circumstances.

*Enforcement*

12.47 The Bank will be enabled to take appropriate enforcement action to ensure compliance. In-line with its broad approach to regulatory oversight, any enforcement action would be taken in a manner that is proportionate and only where the supervisory dialogue cannot reach a satisfactory outcome.

12.48 The Bank will have the following powers of enforcement:

a. Inspection: Where an entity has failed to comply with a notice to provide information, a code of practice, or a direction issued by the Bank, the Bank will have power to commission an inspection. The Bank will require an entity to select an inspector from a Bank pre-approved list of consultancy firms, whereupon the Bank will then commission an inspection. This would apply in both the market oversight and prudential oversight regimes.

b. Inspection Warrant: The Bank will have power to obtain a warrant from the relevant authorities[243] for the inspection of a designated entity's premises. This will be applicable where an entity refuses to comply with a notice to provide information, or a request for an inspection. This would apply in both the market oversight and prudential oversight regimes.

[243] A justice of the peace may on the application of an inspector issue a warrant entitling an inspector, or a constable, to enter premises. In Scotland a justice of the peace includes reference to a sheriff, and in Northern Ireland this includes reference to a lay magistrate.

c. Independent Report: The Bank will have the power to require a designated entity to appoint an independent expert to produce a report on the operations of an entity. A report would be commissioned where there is a failure by an entity to take sufficient account of principles, comply with codes of practice, or it would otherwise assist the Bank in meeting the purpose of this regime. This would apply in both the market oversight and prudential oversight regimes.

d. Publication and Penalty Fees: The Bank will have powers to publish compliance failures and charge penalty fees for compliance failures. The Bank will publish a statement of principles it will apply in determining whether to charge a penalty fee and setting the amount of a penalty fee. These enforcement powers will apply where an entity has failed to comply with codes of practice, a direction issued by the Bank, or a requirement to produce an independent report. This would apply in both the market oversight, and prudential oversight regimes.

e. Closure Order: The Bank will have powers to require an entity to cease operations for all designated activities if a compliance failure threatens financial stability or has serious consequences for business or other interests throughout the UK. Failure to comply with orders made under this power will be a criminal offence, with guilty persons subject to a fine. This would apply only in the prudential oversight regime.

f. Management Disqualification: The Bank may prohibit a specific person from being an operator, or holding management positions, of a designated entity if this is in the interests of financial stability and the purpose of this regime. Failure to comply with orders made under this power will be a criminal offence, with guilty persons subject to a fine. This would apply only in the prudential oversight regime.

g. Warnings: The Bank would be required to provide a warning notice to an entity before the taking of certain enforcement actions. The Bank would provide 21 days for the entity to make representations.

h. Publication and penalty fees. This would apply in both the market oversight, and prudential oversight regimes.

i. Making a closure order or management disqualification under the prudential regime. However, the Bank may without warning make closure orders or management disqualifications if it is satisfied that this is necessary, in line with its functions under the regime.

j. A designated entity will be able to appeal to the Upper Tribunal where the Bank seeks to take enforcement action and has provided a warning, as set out above. The Bank will not be able to take the relevant enforcement action while the appeal is outstanding. This would apply in both the market oversight, and prudential oversight regimes.

k. Injunctions: The Bank may apply to the courts for an injunction where a compliance failure is anticipated, or it has happened and may be repeated.

The courts may make an order restraining the conduct that led to a failure and direct remedying action and/or restrain the entity from dealing with assets.

12.49 The Bank will inform HMT when an enforcement action is taken.

*Fees*

12.50 The Bank will have powers to require designated entities to pay fees to cover its costs for operating the regime. These must relate to a scale of fees approved by HM Treasury by regulation, via the negative procedure. It is the intention that the Bank will consult industry before the scale of fees is recommended to HM Treasury and the scale will be made by regulations.

12.51 On the areas that it is envisaged the fees will cover, it is expected that the vast majority of costs would initially be associated with a small supervisory team. Other incidental costs such as travel, or relevant professional subscriptions related to running the regime are likely to be small. This would apply in both the market oversight, and prudential oversight regimes.

Special Administrative Regime (SAR)

12.52 A SAR is a regime that modifies normal corporate administration procedures in order to ensure continuity of service and minimise disruption to the critical services that are vital to the efficient operation of the financial system. Under the SAR, the Bank has the power of direction over an administrator, having regard to the public interest in protecting and maintaining public confidence in the financial system. Here it would seek to ensure the continuation of wholesale cash distribution activities in the event of an entity entering insolvency and would operate in a similar manner to the SAR for financial market infrastructures. The Bank will have the power to operate a SAR for entities designated under the prudential regime. This would not apply for the market oversight regime.

12.53 The Bank will have the power to apply an appropriate SAR to an entity in the event of its failure or impending failure. A SAR would allow the Bank to apply to court for an administrator to be appointed and to direct the administrator for the relevant entity, thereby giving the Bank an established role in relation to administration and insolvency of the entity.

12.54 The overarching objective of implementing a SAR is the continuance of the entity during failure, either by rescue as a going concern or by transfer where rescue is not reasonably practicable.

Record-Keeping

12.55 The Bank will be required to maintain satisfactory arrangements for recording decisions made in the exercise of its functions under this regime, and to keep those records that it considers ought to be preserved, safe. This would apply in both the market oversight, and prudential oversight regimes.

**Methodology**

12.56 This measure has been assessed against the counterfactual of option 0 – engagement with industry within existing responsibilities and powers.

12.57 The government expects there are both costs and benefits associated with this legislation. It is difficult to provide precise quantitative estimates at the primary legislation stage for all aspects of the regime, as further decisions on designation and the exercise of the Bank's powers will be set out either via secondary legislation or powers delegated to the Bank or HM Treasury.

12.58 The Bank will engage with relevant stakeholders on several aspects of the regime. Where HM Treasury makes statutory instruments via delegated powers, a detailed assessment of the impact of costs will take place.

12.59 However, where possible HM Treasury has provided indicative monetary estimates. To assess the costs and benefits HM Treasury has liaised with the Bank regarding similar activities that are undertaken through existing engagement with industry, and where the Bank operates similar powers under existing regulatory regimes.

12.60 In the assessment of costs, the estimated costs to designated entities of complying with information gathering powers are based on engagement that the Bank has held with industry on their industry-wide commitments to cash.

12.61 The estimated costs to designated entities of complying with an independent report have been assessed based on similar powers exercised by the Bank over systemic payment chains through its powers under Part 5 of the Banking Act 2009.

12.62 Furthermore, the costs to designated entities of fees have been calculated based on the costs associated with the Bank's current engagement with industry on the WDSG industry-wide commitments to cash, alongside any additional costs associated with training and hiring new staff in the Bank.

12.63 It is important to note that the below costs and benefits are illustrative and any costs and benefits to firms will be contingent on the exact nature of the secondary legislation.

12.64 At the point of secondary legislation, and in line with the government's approach to better regulation under the Better Regulation Framework, HM Treasury will make efforts to further consult on and understand the potential further impacts of this measure, including through appropriate stakeholder engagement. More detailed qualitative and quantitative cost-benefit analyses are expected to be covered in the IAs accompanying the relevant secondary legislation enabled by the Bill. HM Treasury will also engage with the RPC, prior to the submission of IAs produced to accompany future secondary legislation where appropriate.

Population within scope of this proposal

*Designation orders*

12.65 HM Treasury will be given the power to designate the following entities:

a. Those who carry out wholesale cash distribution activities.

b. Those who are service providers in relation to the wholesale cash distribution activities.

c. Those who provide financial support or funding in relation to the wholesale cash distribution activities.

12.66 HM Treasury will assess which specific entities will be designated. When assessing whether to designate an entity HM Treasury will notify the relevant entity and consider any relevant representations made, before making a final determination as to whether to designate. This will be done in consultation with the Bank.

12.67 HM Treasury and the Bank do not consider now that any entities will meet the criteria for recommendation for designation under the prudential oversight regime at the outset, but industry developments may necessitate this in the future.

12.68 Entities which are owned in entirety by the Crown are exempt from the prudential oversight powers of this regime. The state-ownership of these entities and their receipt of public funds mean that HM Treasury does not consider it would be necessary, or appropriate, for them to be subject to prudential oversight even if they became systemic in the wholesale network.

**Policy Costs**

Transitional costs to firms

*Familiarisation costs to firms*

12.69 To comply with the new regime, firms will need to familiarise themselves with the relevant legislation and accompanying guidance. Compliance officers will need to familiarise themselves with the primary and secondary legislation, as well as documentation issued by the Bank under this regime.

12.70 A core part of this regime is information-gathering. The key wholesale cash network participants who are likely to fall in scope of this regime already liaise regularly with the Bank and share information. Therefore, it is anticipated that the transition to complying with some elements of the regime should be relatively simple for many, given their familiarity with existing processes.

12.71 Quantifying the familiarisation costs will only be possible once the Bank has finalised its approach to regulation.

12.72 The Bank may incur one-off costs in relation to setting rules and guidance for the regime, as well as developing systems for monitoring and enforcement resulting from the legislation. It is not possible to quantify these costs at this stage.

Ongoing costs to firms

*Continued compliance with reporting and compliance requirements*

12.73 The entities that are regulated by this new regime will need to ensure that they are able to comply with the new regime. This may involve ensuring they have capacity to:

a. Supply relevant information to the Bank, when required.

b. Monitor internal compliance with the regime and any principles, codes of practice, or directions, that are issued.

c. Cooperate with and bear the costs of any inspections or independent reports on the discharge of their operations.

12.74 Information gathering is expected to make up the bulk of activities under this regime. HM Treasury estimates that each designated entity would need between 1-2 full time equivalents (FTE) for 2 working days in order to prepare information requested by the Bank. HM Treasury estimates that designated entities would be asked to provide information at least on a 6-monthly basis, and the resource impact is expected to reduce as the process between the Bank and designated entities becomes more standardised. Under prudential regulation, the frequency of information requests may increase, with additional information on governance and risk reports required. However, this is not expected to substantially increase resource requirements beyond additional 10's of working hours.

12.75 HM Treasury estimates that the Bank will hold 30 minutes bilateral meetings with designated firms on a monthly basis. This equates to approximately 6 hours per year of meeting time, and it is estimated that approximately 1.5 hours of preparation time would be required for each meeting. This equates to approximately 10 hours per year of preparation time by a designated entity. It is estimated that the Bank will hold an additional annual meeting with each designated firm to discuss broader business plans. This is expected to last between 2-3 hours, with a preparation time by a designated entity of approximately 6 hours. For the monthly and annual meetings, under prudential oversight, it is estimated that the Bank would hold two annual meetings instead of one. However, this is not expected to substantially increase resource requirements beyond additional 10's of working hours.

12.76 Some additional resources may be required by a designated firm to comply with any principles, codes of practice, or directions that are issued by the Bank. However, it is not possible to quantify the impacts of this, as they have not yet been issued by the Bank. The Bank will engage with industry on the development of these.

12.77 The actual resource impact on an entity of complying with the regime will depend on an entity's existing standards and practices. Many entities already regularly provide information to and engage with the Bank. The actual impact of the regulation will therefore be lower for these firms.

12.78 HM Treasury estimates that the costs to a designated entity of complying with an independent report would be between £75k - £200k per review. It is expected that the Bank would require an independent report rarely, if at all, under the market oversight regime and approximately every 1-2 years under the prudential oversight regime. An entity would be required to select a firm to conduct the report, from a list that has been pre-approved by the Bank. The firm chosen would affect the cost of the report.

12.79 Systemic firms subject to the prudential regime may be subject to additional supervisory and compliance requirements, given the greater risk to financial stability from disruption of their services.

12.80 In-line with other regulatory activities undertaken by the Bank, the Bank will seek to exercise its powers in a proportionate manner that is consultative and seeks to employ regulatory dialogue before exercising enforcement powers.

*Payment of annual fees to the Bank*

12.81 In order to pay for the continued policy costs that the Bank will have to spend on the regime, designated entities will have to pay annual fees to the Bank.

12.82 It is estimated that annual fees charged to designated entities would be approximately £75k per annum. However, this will be quantified further when fees are determined by a fee scale laid by HM Treasury via a statutory instrument. Designated entities will also be consulted by the Bank on the development of a fee scale.

*Possible fines and enforcement action*

12.83 Designated entities may be subject to penalty fees for compliance failures. Full details about the size of these fines will be set out when the Bank publishes a statement of principles that it will apply in determining whether to charge a penalty fee. There may also be costs incurred by an entity due to any enforcement action which may need to be taken by the Bank. The scale of this would dependent upon the action taken and the circumstances, and so cannot be estimated.

*Costs of a closure order*

12.84 An entity that presents a risk to financial stability or has serious consequences for business or other interests throughout the UK, due to compliance failure, may be subject to a closure order that would require it to cease operations for a specified period of time, or indefinitely.

12.85 In other regulatory regimes where the Bank has similar powers, such as those for systemic payment systems, the Bank has never exercised this power. Therefore, a cost estimate cannot be made based on the exercise of a similar power under another regime.

*Costs of a management disqualification notice*

12.86 Where it is in the interests of financial stability, or the purpose of this regime, a person(s) may be disqualified from being an operator, or holding management positions, of a designated entity.

12.87 In other regulatory regimes where the Bank has similar powers, such as those for systemic payment systems, the Bank has never exercised this power. Therefore, an estimate cannot be made based on the exercise of a similar power under another regime.

*Costs of an injunction*

12.88 An entity that presents a risk to financial stability, or the purpose of this regime, due to a compliance failure, may be subject to an injunction request to the courts to require the entity to not take or cease specified actions.

12.89 In other regulatory regimes where the Bank has similar powers, such as those for systemic payment chains, the Bank has never exercised this power. Therefore, an estimate cannot be made based on the exercise of a similar power under another regime.

**Policy Benefits**

Ongoing benefits

*Benefits to industry: Sustainable, effective, and resilient business model*

12.90 This regime seeks to mitigate the risk of unexpected and/or disorderly consolidation and rationalisation and ensure that changes in the wholesale cash network account for the wider needs of the entire cash infrastructure.

12.91 By seeking to ensure the wider sustainability, effectiveness, and resilience of the wholesale cash network, this regime will provide benefits for individual industry participants by seeking to ensure that any significant changes in the network are orderly and without unnecessary disruption. As a result, this will reduce the risk of industry participants needing to adapt, without warning, to unexpected developments such as a cash centre closure, or a significant merger, in the network.

12.92 Furthermore, a sustainable, effective, and resilient wholesale cash network will also benefit the wider UK cash infrastructure as a whole. By overseeing wholesale cash distribution market activities, this regime will seek to ensure that decisions made by wholesale industry participants take account of the wider cash infrastructure. The Bank will achieve this by using its powers to build a picture of developments across the wholesale network.

12.93 This will reduce the risk of decisions being made that cause disorder or fragmentation in the network, without a plan to manage these risks. This measure also seeks to ensure that systemic entities are prudentially regulated, where appropriate, to reduce the risk of a serious disruption in the network in the event of failure. Reducing the risk of failure in a systemic entity will help to mitigate the likelihood of a disruption that threatens the ability of the network to continue functioning.

*Benefits to industry: Supply of cash to retail infrastructure*

12.94 For cash intensive businesses and/or providers of cash access in the retail infrastructure, a sustainable wholesale cash network is key to ensuring a continued, reliable supply of cash. This will benefit all retailers who handle high volumes of cash – both small and large retailers. By seeking to ensure the sustainability, effectiveness, and resilience of the wholesale cash network, this measure will reduce the risk of serious disruption to the supply of cash. This will be of benefit to businesses, such as independent ATM deployers, who rely on wholesale cash services as an integral part of their business model.

*Benefits to consumers: Financial inclusion benefits*

12.95 The FCA's Financial Lives Survey found that 5.4 million adults, particularly those in vulnerable groups were reliant on cash as of February 2020[244]. Groups who rely on cash to a great or very great extent include those aged 85+ (42%), the digitally excluded (46%), those with no educational qualifications (31%) and those in poor health (26%). Under half (45%) of adults who rely on cash to a great or very great extent do so for budgeting reasons (e.g. to help them budget (33%) or to avoid getting into debt (24%)). One in three (33%) rely on cash because they trust it more than other payment methods. The survey also found that one in ten (10%) do not know how they would cope or say they would not cope at all in a cashless society. These findings were reflected through responses to the government's Call for Evidence on Access to Cash in 2020[245].

12.96 Whilst it is expected that there will be further adoption of digital payment methods over time, it is important that those that have not yet made or will not be able to make the transition continue to have access to cash.

*Benefits to consumers: Desire to use cash as a 'store of value'*

12.97 Although the use of cash to buy and sell goods and services has declined in recent years, the value of banknotes in circulation has increased. People may want to use cash as a 'store of value' rather than holding it in a bank, building society or another form of savings account.

*Benefits to consumers: Cash as a "backstop" method of payment*

12.98 There are isolated incidents where people have been unable to make digital payments and have instead reverted to using cash. During an international outage of the Visa payment system in 2018, many retailers only accepted payments made in cash. This underlines the importance of cash as a 'backstop' method of payment.

12.99 Given this, in the event of disruption to other payment methods, a serious disruption to cash supply could threaten financial stability and/or confidence in the financial system of the UK. This measure seeks to ensure that systemic entities in the wholesale cash network are prudentially regulated, where appropriate, to mitigate the risk of serious disruption that the failure of a systemic entity would cause. The benefit to financial stability will have wider benefits to consumers and the UK.

**Assumptions, limitations, and considerations**

12.100 Costs to designated entities have been estimated using some assumptions. Firstly, HM Treasury has estimated costs based on the assumption that the level and type of engagement associated with information gathering and the key aspects of the regime will build on the Bank's current engagement with entities' commitments to cash.

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244 FCA (February 2020) "Financial Lives Survey" https://www.fca.org.uk/publication/research/financial-lives-survey-2020.pdf

245 Access to Cash: Call for Evidence – Summary of Responses (July 2021) https://www.gov.uk/government/publications/access-to-cash-call-for-evidence

12.101 Furthermore, for those costs associated with powers that mirror those already exercised by the Bank under other regulatory regimes, costs have been estimated based on the assumption that costs will be similar due to the same processes and institutional approach that the Bank will apply.

**Small and MicroBusiness Assessment (SaMBA)**

Number and distribution of businesses in scope of the regulation

12.102 Under this measure, HM Treasury will designate entities in the wholesale cash industry as having market significance or systemic significance to the industry. HM Treasury has provided an indicative assessment of the number and distribution of businesses in scope based on publicly available data. HM Treasury is unable to definitively specify the number of firms in scope of this measure because decisions on the formal process of designation of individual entities under this measure have not yet been made, and will occur following commencement of the provisions in the Bill.

12.103 Following informal engagement with the Bank and the industry, at present HM Treasury estimates that there are eight key participants in the wholesale cash market who are of market significance. Using publicly available data published by the entities in question, it is considered that none of the entities are SMBs – using the definition of firms with less than 50 employees or turnover of less than £10 million per year. HM Treasury does not currently consider any entities of any size to be of systemic importance. As such, no SMBs are expected to fall within scope of the measure.

Do the impacts fall disproportionately on small and microbusinesses?

12.104 As above, no SMBs are considered to fall within scope of this measure, and so no disproportionate costs are expected to fall upon them. HM treasury expects SMBs will indirectly benefit from this measure by ensuring the stability of the wholesale cash industry and helping mitigate large increases in the costs of accepting cash for retailers including SMBs.

Could small and microbusinesses be exempted while achieving the policy objectives? Could the impact on small and microbusinesses be mitigated while achieving the policy objectives?

12.105 As above, there is no need to exempt SMBs or consider any mitigations to SMBs, as none are expected to fall within scope, and the requirement for the entity to have market significance or systemic significance is, in practice, likely to have the effect of exempting smaller firms (although it does not explicitly do so, and the possibility that a SMB could be considered to have either market or systemic significance in the future cannot be definitively ruled out). Because of the nature of the functions involved in wholesale cash processing across the UK, which require a significant footprint of operations and staffing, which could not be provided by a SMBs.

12.106 As above, no small- or micro-businesses are expected to fall within scope of the measure.

Wider impacts on small and microbusinesses.

12.107 Regarding the broader impact on SMBs, as explained previously HM Treasury expects that small businesses will benefit from this measure. It gives the Bank the powers needed to ensure the wholesale cash system remains effective, sustainable and resilient, and continues to support continued access to cash for the public through retail provision (i.e. at ATMs, bank branches, and in retailers). Ensuring the stability of the industry, it should help mitigate large increases in the costs of accepting cash for retailers (SMBs).

12.108 Research commissioned by the Payment Systems Regulator (PSR) in 2019 found that over half of the small businesses surveyed (54%) accepted cash, rising to 91% for accommodation and food services, with the lowest sector reported as professional services (34%).[246] Of the businesses reporting as accepting cash, three quarters (75%) had deposited cash in the bank within the previous month – this was higher than the proportion of respondents reporting that they had used cash they had accepted in order to maintain a float (34%) or to pay suppliers (22%). A survey commissioned by the FCA in 2021 found that 98% of small businesses surveyed would never turn a customer away if they needed to pay in cash, while almost eight in 10 say they are 'very likely' to accept cash over the next five years.[247] Cash can also be recycled through these businesses if they pay suppliers and employees in cash, or it is taken as personal wages.

12.109 This demonstrates that while cash payments are declining, cash still forms an important part of the suite of payment methods used by small businesses. This measure seeks to ensure the long-term, sustainable functioning of the wholesale cash network and, therefore, the ongoing supply of cash to small businesses. A more sustainable, effective, and resilient wholesale network may also lead to efficiencies that, when passed onto retailers and consumers, could reduce the cost of handling cash for all businesses in the UK.

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[246] Access to cash full report, PSR, July 2019

[247] Cash acceptance within SMEs research, FCA, 2021

## Credit Unions

**Problem under consideration**

13.1 Credit unions are small, financial cooperatives owned by their members. Most credit unions have less than £5 million in assets, and the largest credit union has around £210 million in assets and 55,000 members.

13.2 In Great Britain, they are governed under the Credit Unions Act 1979 ("the 1979 Act"). The 1979 Act sets out the purpose of a credit union and specifies the products and services that they can provide. It lists four "objects"[248] which set out their purpose. These are:

a. The promotion of thrift among the members of the society by the accumulation of their savings;

b. The creation of sources of credit for the benefit of the members of the society at a fair and reasonable rate of interest;

c. The use and control of the members' savings for their mutual benefit; and

d. The training and education of the members in the wise use of money and in the management of their financial affairs.

13.3 In addition to this, credit unions have a set of rules which govern their relationship with members and their governance. For example, credit unions will set out the objects stated above, which are mandatory for credit unions to follow, as well as their common bond[249], minimum shareholding requirements, or if the credit union should allow corporate members.

13.4 The current scope of the 1979 Act has meant that credit unions primarily offer savings accounts and loans to their members, with some offering a slightly wider range of products and services such as mortgages. In the 2020 Budget, the Chancellor committed "to bring forward legislation to allow credit unions to offer a wider range of products and services to their members, supporting their vital role in financial inclusion."[250]

13.5 The Association of British Credit Unions Limited (ABCUL) ran a sector-wide consultation in 2019 named "Vision 2025".[251] The consultation highlighted that credit unions were interested in offering services beyond those which they were legally allowed to offer. There was strong interest from credit unions in being able to offer car finance (70%), and insurance distribution (49%). Being able to offer

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248 "Objects" is an antiquated term for "objectives"

249 In order to be a member of a credit union, an individual must fall within the "common bond" of the credit union. As an example, the common bond can be based on geographical location or being employed by a particular employer.

250 https://www.gov.uk/government/publications/budget-2020-documents

251 https://www.abcul.coop/HigherLogic/System/DownloadDocumentFile.ashx?DocumentFileKey=b96444dc-8a59-7117-a057-c4c9ad2c9f86&forceDialog=0

these additional products would allow credit unions to diversify their incomes and support financial inclusion by providing further opportunities for the credit union sector to grow and expand their reach to new customers as providers of affordable credit.

**Rationale for intervention**

13.6 This legislation will introduce greater flexibility to the 1979 Act to allow credit unions to provide further products and services in future and help support the growth and development of the British credit union sector.

13.7 Currently there is market failure arising from credit unions not being able to offer HP/CS agreements and insurance distribution services. As they are currently not able to offer these services they are underprovided by the free market leading to market failure.

13.8 Credit unions, as well as the FCA as the registering authority for credit unions, would benefit from greater clarity in the 1979 Act as to the ability for credit unions to borrow from other credit unions. This Bill will therefore provide this clarity.

13.9 Credit unions also do not currently need to submit their annual accounts to the FCA in its capacity as registering authority for credit unions under legislation. Amending this would ensure greater regulatory oversight.

**Policy Objective**

13.10 This policy will allow credit unions to offer a broader range of products and services and allow credit unions to better support their members.

**Description of Options Considered**

13.11 Option 0: Do nothing – if the government did not change the credit union legislation, then credit unions would not be able to offer a wider range of products and services. In turn, credit unions' income would likely be lower than if the legislation was amended, which may hinder the ability of the sector to grow and offer access to affordable credit for those who use it. There would also be continued legal ambiguity as set out above, which would lead to a limited capacity of credit unions. This in turn would limit credit unions' market power and their competitiveness.

13.12 Option 1: (Preferred option) Amend the Credit Unions Act 1979 to allow credit unions to offer Hire Purchase / Conditional Sales (HP/CS) agreements and wider insurance distribution services beyond those that are ancillary to making loans or deposit-taking; and make technical amendments to correct legislative defects. This will allow credit unions which wish to expand and offer new services to their members to do so, within the revised legislative perimeter, without impacting credit unions that want to maintain their existing model. Taking a secondary power to allow HM Treasury to widen the services that credit unions are able to offer in future will provide greater flexibility to the credit union model. Expressly allowing credit unions to borrow from other credit unions and putting in statute the legal requirement to submit annual accounts to the FCA will also provide greater certainty for the sector in continuing existing operations.

**Outline of preferred policy**

Offer additional products

13.13 This Bill will make amendments to the 1979 Act to allow credit unions to offer a wider range of products and services. The Financial Services and Markets Bill will explicitly allow credit unions to offer two new services:

13.14 Hire purchase (HP) / conditional sales (CS) agreements. These agreements are different in structure but are similar in that members of the credit union will be able to choose a product, pay a deposit, and the credit union will own the item while the member uses it and makes payments to the credit union until it is paid off. The member will repay the credit union the value of the item plus interest in instalments. The agreements usually include the condition that the goods don't belong to the member until they have paid the final instalment and the credit union may be able to repossess the goods if the member falls behind with payments. The Government's engagement with the sector suggests that this will mainly be used provide car finance, and the ABCUL's Vision 2025 explicitly stated that these will be used to finance cars. However, in theory they could be used for other goods where finance might be needed (e.g., household appliances).

13.15 Insurance distribution services. This will allow a credit union to undertake wider insurance distribution activity than currently permitted, which may include introducing members to an insurer or proposing a wider range of contracts of insurance to their members. Members may want to use this as it may help them to find an insurance policy more quickly and easily. The relationship between credit union and members may also allow for greater customer engagement in this space, compared to distribution through other channels, e.g., a price comparison website. The FCA provides full guidance on what this is likely to involve.[252]

13.16 HM Treasury will, in future, be able to lay secondary legislation to allow credit unions to offer additional products and services. HM Treasury will submit a secondary impact assessment for any policy changes to allow credit unions to offer additional products and services if/when this power is used.

Allowing credit unions to borrow from each other

13.17 The Bill will explicitly allow credit unions to temporarily borrow from each other. This will be subject to lending limits in PRA rules and the legislative 3% cap on credit union lending. This will be optional for credit unions, and the government expects it to be used in situations where it may be beneficial for them to manage their liquidity, not as a new service.

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[252] https://www.handbook.fca.org.uk/handbook/PERG/5/?view=chapter ;

https://www.handbook.fca.org.uk/handbook/PROD/4/3.html ;

https://www.handbook.fca.org.uk/handbook/ICOBS/2/5.html

Requiring credit unions to submit annual accounts to the FCA

13.18 This measure will require credit unions to submit annual accounts to the FCA. The FCA is the registering authority for credit unions and credit unions are already required to submit annual accounts to the FCA by the Credit Unions sourcebook (CREDS), which are rules created by the FCA[253]. Furthermore, credit unions are also already required to submit regulatory returns to the PRA on at least a quarterly basis.[254] Therefore, the government does not believe that this will create additional costs for credit unions or the FCA.

13.19 Currently, the lack of a legislative requirement to do this means that the FCA is unable to take the same legislative action against credit unions as they can for other mutual societies for failing to submit annual accounts. Therefore, one benefit of this measure is that it will reinforce the importance of credit unions submitting annual accounts and ensure the FCA can properly scrutinise them.

13.20 In its capacity as registering authority, the FCA publishes the accounts of mutual societies, including credit unions, on the Mutuals Public Register. Having a clear legislative requirement in place helps facilitate this - ensuring that credit unions, their members and others are able to view the accounts on a public register as with other types of legal entity.

**Methodology**

13.21 The policy costs and benefits have been assessed against a counterfactual of not making the changes. This bill will not require credit unions to offer hire purchase, conditional sales agreements or insurance distribution services, but it instead provides them the opportunity to do so. The choice to offer these services will be a commercial decision for the credit union, depending on member demand. However, as the government expects some credit unions to take up the additional services, analysis of the potential benefits and costs of credit unions offering the new services using available data is provided below. Any cost will only be incurred should the credit union offer each specific service.

13.22 This assessment uses available evidence from published data and research and all estimates are indicative only, and sensitive to underlying assumptions. It takes into account the sector-wide "Vision 2025" consultation from ABCUL[255], further formal and informal consultation discussions ABCUL held with its members, and discussion with the Building Societies Association (which represents six of the larger credit

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[253] https://www.handbook.fca.org.uk/handbook/CREDS/8/2.html

[254] https://www.bankofengland.co.uk/prudential-regulation/regulatory-reporting/regulatory-reporting-banking-sector/credit-unions

[255] In 2019, ABCUL ran a consultation over 8 months with the credit union sector to develop a shared vision for the future of British credit unions. Vision 2025 is the output of the consultation. ABCUL met with representatives from credit unions across the country – both ABCUL members and non-ABCUL members alike – during a series of Town Hall events in Birmingham, Cardiff, Glasgow, Liverpool, London, Taunton, and York. ABCUL canvassed views through formal consultation events, events with members, individual meetings with credit unions, and an online survey. ABCUL also engaged with relevant stakeholder groups with links to credit unions. For example, ABCUL held discussions with, and gathered feedback from, back office I.T. suppliers, key stakeholders such as Fair4All Finance and its strategic insurance partner CMutual, and a focus group with The Credit Union Foundation, ABCUL's charitable arm.

unions in Great Britain), and engagement with the National Liaison Group (including the National Credit Union Forum), which covers credit union trade bodies and representative groups across the UK.

13.23 It also draws on statistical data produced by the Bank of England (Bank), the ONS and industry organisations such as Autotrader. The analysis assumes a standard appraisal period of 10 years.

13.24 As many of the changes are made in primary legislation, an EANDCB has been provided for the familiarisation costs based on the assumption that all credit unions will familiarise themselves with the legislation, even if they do not subsequently make any changes to their business plans.

Population within scope of the proposal

13.25 The analysis requires an estimate of the number of credit unions that will offer the new services. At the time of conducting this assessment, the PRA estimates there are 240 credit unions in Great Britain.[256] In 2019, the ABCUL ran a consultation to examine the future of the credit union sector, and what challenges and opportunities were available. They ran six town hall events across the UK and sent out an online questionnaire to those credit unions which were not able to attend the town hall events.

13.26 As noted above, 70% of credit unions indicated that they wanted to offer car financing in the form of HP/CS, and 49% of firms wanted to offer insurance distribution services. In the absence of any additional data, these are taken to be the best estimate of credit unions which will decide to offer these services.

13.27 Therefore, it is anticipated that these changes will lead to 168 credit unions offering car finance services in the form of HP/CS (70% of the 240 total), and 118 credit unions offering insurance distribution services (49%). The survey data from the ABCUL does not differentiate between firms that will offer one or both of the services – it is likely that there will be an overlap between the credit unions offering HP/CS agreements and the credit unions offering insurance distribution services.

Take up rate by Credit Unions

13.28 Not all credit unions will be able to offer the new services immediately. Each credit union will be starting from a different level of existing capability and the take up rate will depend on individual business strategies tailored to the needs of members. Furthermore, credit unions will need to obtain the relevant regulatory permissions, amend their rules, and invest in their capacity to be able to offer the new services, which will take time. To determine the take up rate accurately would require significant further analysis of credit unions' existing capabilities and extensive engagement with all credit unions over their future business plans. This would be disproportionate considering the calculated impact of this measure.

256 https://www.bankofengland.co.uk/statistics/credit-union/2020/2020

Proportionality

13.29 The evidence of the benefits and costs associated with the proposed intervention is very limited, however the initial assessment of the potential sources of costs and their order of magnitude concluded that the costs would be small.

13.30 At this time HM Treasury has only been able to monetise the familiarisation cost, however, credit unions may face costs in developing and offering insurance distribution services and HP/CS agreements, if they choose to do so. These could include developing new IT systems, changes to processes and employing new staff. There is insufficient evidence to quantify the indirect costs or benefits in this Impact Assessment, but the indirect costs will only be incurred by industry if commercial benefits outweigh them. They are therefore excluded from the EANDCB. This approach is the same taken in Pathway to Driverless Cars: Insurance for Automated Vehicles.[257] It is expected that credit unions will only take up these new products and services if they make a business decision to do so, meaning this is an optional cost to credit unions.

**Policy Costs**

13.31 There will be some costs to credit unions to offering these services, particularly familiarisation costs of reading, complying with regulation, and developing their capability by updating systems and controls, policies, procedures, and training[258]. However, in the long run, the benefits for credit unions offering these services will outweigh the costs and the costs will only be incurred if the credit union chooses to offer the services. Given that it is optional for a credit union to offer these new products and services, credit unions would be expected to ensure that any costs incurred in familiarisation and product design are proportionate to the return provided on new products.

Transitional costs to firms

*Familiarisation costs of the legislation for credit unions*

13.32 Through discussions with the ABCUL and the BSA, it is understood that credit union employees will need to familiarise themselves with the new legislation and undertake due diligence to understand the authorisations and permissions required under the relevant regulatory handbooks[259] regarding the new services, in order to consider whether or not to choose to offer them.

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[257] https://www.parliament.uk/globalassets/documents/impact-assessments/IA17-008A.pdf

[258] Considered through discussion with ABCUL, the BSA, and PRA.

[259] These include: Chapter 5 of the Perimeter Guidance Manual (PERG 5), while noting that credit unions that offer ancillary insurance distribution will already be familiar with this manual; the relevant parts of the Insurance: Conduct of Business Sourcebook (ICOBS); the prudential sourcebook for Mortgage and Home Finance Firms, and Insurance Intermediaries (MIPRU); the application of SYSC requirements for insurance distribution obligations, including specific requirements in SYSC 10 and 28; and the relevant sections of the Consumer Credit Sourcebook (CONC).

13.33 Although it is estimated earlier that 86 credit unions would want to undertake HP/CS, 36 to undertake insurance distribution, and 82 to undertake both, it is assumed that all 240 credit unions will become familiar with the changes in order to make the business decision as to whether to offer these products and services.

13.34 HM Treasury asked the ABCUL, as the largest trade association for credit unions in Great Britain (GB), to engage with their members to collect evidence on the time it would take for credit unions to become familiar with the legislation, including the different job roles that might be involved, the number of days it might take to become familiar enough with the changes to determine whether to choose to offer them, and any external advice that might be needed.

13.35 Although it is difficult to calculate the cost of legal support for this specific measure given it is for the individual credit unions to consider, the ABCUL shared a previous example for the purpose of this impact assessment where ten credit unions jointly procured and shared the legal cost for understanding options to provide motor finance. This cost a total of £25,000, so each participating credit union paid £2,500 for the service. HM Treasury estimates that this measure would require a comparable task for each credit union to familiarise themselves, so a total legal cost of £600,000 for the sector (£2,500 x 240 credit unions). This is an approximate, likely upper, estimate and should be taken with the caveats that some credit unions may not look into offering the new products and services at all, while some may be able to build this cost into their ongoing ABCUL membership fees where the trade body might choose to source the legal work for its members.

13.36 In terms of staff familiarisation with the measure and associated products, the ABCUL estimates that it would take, on average, roughly one week per job role for each credit union to review and understand the changes well enough to be able to make a decision as to whether to progress to potential product development stage. The ABCUL has stated that within that week, the various post holders outlined below would review the information provided by the legislation and the regulators directly, as well as go through ABCUL training sessions and the information guides that ABCUL will produce, and reach out directly to their trade body for any specific queries. The ABCUL suggests that these would lead to in-house meetings with other members of staff to discuss options or any concerns. This would then lead to staff being able to come to a recommendation to put to their governing body on whether to progress with any of the additional products and services. HM Treasury attempts to calculate the costs of familiarisation below.

13.37 The ABCUL estimates that larger credit unions, defined by ABCUL as having over £10 million in profits, would have about three or four staff members and usually one Board member get involved in the familiarisation. To note, there has been insufficient data to estimate additional costs such as further IT, desk space, employer National Insurance contributions, or employer pension contributions. Instead, this analysis will focus on estimated salary figures (based on 2021 benchmarking provided by ABCUL for the purposes of this impact assessment) for different positions as a representation, shown below:

a. CEO/Manager (£50k) [£962 per week]

b. Assistant manager (£30-35k) [£635 per week, estimating £33k salary]

c. Finance officer (£25k) [£481 pw]

d. Compliance officer (£25k) [£481 pw]

13.38 Based on figures provided by the PRA for the purposes of this impact assessment[260], it is assume that there are 40 larger credit unions using the above definition. It would equal £2,559 per large credit union (reached by combining the weekly pay for each employee role above) for each of the four employees above to familiarise themselves enough to make a decision as to whether to recommend to the governing body that the credit union offer the new products or services. This means that it would cost £102,360 for the larger credit unions to familiarise themselves with the legislation (£2,559 x 40 credit unions).

13.39 ABCUL estimates that smaller credit unions would likely just have the CEO/manager and volunteer board reviewing the legislation. Based on their 2021 benchmarking, they estimate that the CEO/manager of a smaller credit union would make an average of £30,000 per year.

13.40 Based on figures provided by the PRA, the analysis assumes that the rest of the credit unions, or 200, would be defined as smaller credit unions under the definition above. Calculating the weekly salary of a CEO/manager on a £30,000 salary (£30,000/52 weeks), we assume that it would cost each smaller credit union roughly £577 to become familiar with the changes in order to make a decision as to whether to offer any of the new products or services. This means that it would cost £115,400 total for smaller credit unions to familiarise themselves with the legislation (£577 x 200 credit unions).

13.41 In total, this gives an upper estimate for the familiarisation cost to the sector of £217,760 (£102,360 total for larger credit unions plus £115,400 total for smaller credit unions).

13.42 **The familiarisation costs are estimated to be £817,760. This includes legal costs of £600,000 (para 13.35) and the cost of senior managers familiarising themselves with the legislation to make a decision as to whether to recommend to the governing body to allow them to offer the new products or services of HP/CS insurance distribution (para 13.41). The best estimate for the EANDCB for this measure is therefore £0.08m.**

13.43 This estimate should be caveated. The legislation does not require any credit union to familiarise themselves with the new options, and some could decide not to. This amount could also differ depending on the capacity of the credit union, meaning that it might take some credit unions more time and some less time than estimated to familiarise themselves. As noted earlier in this impact assessment, the capacity varies significantly across the sector, which will impact familiarisation.

*Cost to credit unions for amending their rules*

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260 In discussion with the PRA and HMT

13.44 Credit unions will need to amend their rules to allow them to offer any of the new services to their members. This will involve submitting a rule amendment to the FCA and ratifying the change at a general meeting.

13.45 All rule amendments submitted to the FCA must be accompanied by a witnessed statutory declaration – the ABCUL has estimated that this will require a solicitor to witness a statutory declaration, which will cost £100.[261] Even if credit unions choose to offer both services and take them up at separate times, only one rule change is needed for credit unions as both HP/CS agreements and insurance distribution services are covered under the new object.

13.46 To make rule amendments, a credit union will need a specified majority vote at a general meeting of members. It is assumed that credit unions will use their annual general meetings to ratify their rule changes[262]. As these meetings would take place regardless of the changes, no additional cost is incurred.

13.47 A credit union may choose to incur the cost of holding a special general meeting to adopt the new object without waiting for the next annual general meeting. However, they are likely to do so only if they regard it as highly desirable to be able to commence the new activity without delay, to the point of accepting the optional cost of a special general meeting.

13.48 Additionally, any changes to rules may incur cost in terms of staff time, member consultation, preparation of papers for the discussion, and any relevant legal advice required[263]. However, for the 160 ABCUL members at least, the cost of these changes will likely be borne by ABCUL in designing new model rules, meaning there will be minimal cost to the credit unions themselves for a rule change. HM Treasury's discussion with the BSA and the regulators also suggest that any costs for making rule changes would be minimal.

*Variation of permission fees for credit unions*

13.49 In order to offer the new services, credit unions will need to hold the relevant permissions from the FCA. Unless they already hold these permissions, they will need to apply for a "variation of permission" (VOP) application to the FCA and PRA.

13.50 Permissions are needed when a financial services firm wants to offer a particular regulated activity by way of business. They must apply for authorisation from a regulator (in this case the FCA and PRA) before they can undertake that activity. If the regulators approve that application, then the credit union can offer the product in compliance with the relevant sections of the regulator handbook and their own legislation.

13.51 A VOP application will cost the credit union £250 to submit to the FCA, regardless of the number of permissions that are being added, and £125 to submit to the PRA.

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261 Estimation provided by ABCUL

262 Based on discussions with ABCUL

263 Based on discussions with ABCUL

However, it is not possible to anticipate whether a credit union might choose to take up each service at separate times or at the same time. As of August 2021, 22 credit unions already hold the general consumer credit permissions needed to offer HP/CS agreements[264], 35 credit unions hold permissions to offer insurance distribution services.[265] These credit unions will not require a VOP.

13.52 On top of VOP fees, credit unions will incur one-off compliance costs to ensure that they can comply with the FCA's regulation on consumer credit. This will affect the 168 credit unions which would offer HP/CS agreements.

13.53 Currently, credit unions have their own dedicated rulebook at the FCA, known as CREDS.[266] However, if they choose to offer HP/CS agreements which are regulated activities, they will be subject to CONC, the consumer credit sourcebook. They will therefore be subject to higher compliance costs.

13.54 In 2014, the FCA took over responsibility for the regulation of consumer credit from the Office of Fair Trading (OFT). For this transfer, they produced an assessment[267] of the costs of the transfer and the cost of consumer credit regulation.

13.55 The analysis from the FCA showed that the one-off cost excluding fees of firms transferring to the new regime in 2013 to all consumer credit firms was £47.5m-£77.3m[268]. Updating this to 2020 prices means this would now be between £55.56m and £91.80m.[269] It is assumed that the same costs will apply to credit unions if they wish to offer HP/CS agreements which are regulated activities as they will need to become consumer credit regulated to do so.

13.56 The PRA has noted that there are currently 240 credit unions in Great Britain, making up 0.65% of all consumer credit firms. Assuming these costs are spread evenly across firms, 0.65% of the costs above are £361,140 (0.65% of £55.56m) and £596,700 (0.65% of £91.80m). As only 70% of British credit unions will offer HP/CS agreements, the estimated one-off cost across the whole appraisal period reduces to between £252,798 and £417,690.

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264 These credit unions needed to apply for permission to do this lending from the regulators. The specific lending permissions they have are called "consumer credit lending permissions", which allows the financial institution to carry out a broad range of consumer credit lending activities as defined under this specific permission, subject to compliance with the FCA handbook and their legislation. HP/CS agreements are included in those "consumer credit lending permissions" and thus the 22 credit unions already hold the right regulatory permissions. However, they cannot offer these services because credit union legislation does not permit it.

265 Credit unions are legally allowed to offer limited insurance distribution services, but only when it is ancillary to offering a loan or taking a deposit, hence why 35 have permissions.

266 https://www.handbook.fca.org.uk/handbook/CREDS/1/?view=chapter

267 https://www.fca.org.uk/publication/consultation/fsa-cp13-07.pdf

268 https://www.fca.org.uk/publication/consultation/fsa-cp13-07.pdf. Page 129

269 Uses GDP deflators published on 27th October 2021 in the Impact Assessment calculator Impact assessment calculator - GOV.UK (www.gov.uk)

13.57 There are no one-off costs from insurance distribution services to consider. The regulation of insurance distribution services is currently set out in FCA rules, including PROD[270], and some of the retained laws, regulations and rules that originally implemented[271] the Insurance Distribution Directive ('IDD'). The directive[272] came into force in October 2018 and was implemented into FCA rules after consultation. It should be noted that FCA rules go beyond the IDD in a number of areas in relation to firms undertaking insurance distribution activities.

13.58 FCA rules impose some requirements on firms offering insurance distribution services. In February 2018, PwC published a document which set out the key potential impacts of the IDD.[273] The FCA consulted on the implementation of the IDD in 2017, including focusing on new areas where they were going beyond the minimum requirements.[274] Many of the key impacts covered by PwC and the FCA in this paper are not expected to create a one-off cost for credit unions. This is because credit unions will not be involved in manufacturing insurance policies; already have well-established relationships with insurers; are expected to focus more on distributing more general insurance products like contents insurance based on engagement with the sector; and are expected to be able to meet the requirements around the insurance demands and needs of their members as their primary purpose is to serve their members. Additionally, whilst credit unions will need to comply with disclosure and other requirements whether in legislation or in FCA rules, the costs of incorporating this into their processes will be captured in the costs credit unions incur when investing in their capability and developing their processes. These costs are explained under the section titled "Investment in additional capability for credit unions".

13.59 This analysis is limited in that there is no assessment available of the impact of the minimum IDD requirements. Whilst the FCA did consult on the implementation of the IDD in 2017, their cost/benefit analysis did not assess the impact of the minimum requirements themselves. Additionally, the FCA rules and requirements go beyond the minimum of the IDD, which this assessment is unable to quantify. It would be disproportionate to assess this for this measure as credit unions will make up a very small percentage of the insurance distribution market.

*Investment in additional capability for credit unions*

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270 https://www.handbook.fca.org.uk/handbook/PROD/4/3.html

271 The IDD was mainly transposed into UK law through legislation, regulations and FCA rules.

272 The IDD itself has not been retained as it did not have direct effect in the UK [however regulations made under the directive were retained].

273 https://www.pwc.co.uk/financial-services/assets/pdf/insurance-distribution-directive-are-you-ready-january2018.pdf

274 https://www.fca.org.uk/firms/insurance-distribution-directive It should be noted that FCA rules often go beyond the IDD as a minimum.

13.60 Beyond one-off regulatory compliance costs, credit unions which decide to offer these additional services may need to invest in their capability so that they can offer these services. These permissive costs may include:

a. Improving the loan application assessment model to account for different features of the new products (e.g., depreciation of a car).

b. Design of the new customer journey, amendment of loan policy, and building of business case for new product

c. Establishing relationships, contracts, forms and agreements with insurance firms to whom credit unions will refer members.

d. Marketing for the new products in their branches and by changing their websites to attract members.

13.61 In the absence of readily available estimates, to support the development of this impact assessment, HM Treasury discussed with the ABCUL (the trade body which represents credit unions) and surveyed credit unions to find out the cost of launching the new services. Three responses were received, and these were £25,000, £75,000 and £560,000. These estimates have come from credit unions of varying sizes who have previous experience of developing new products. This variation also reflects the different positions of existing credit unions, including their in-house resource, current capability, and the proposed scale of their product offering. For example, one credit union noted that obtaining professional guidance for their new product would have been disproportionate for the scale of their proposed product offering and a lot of their costs were covered by external partners with whom they have pre-existing relationships.

13.62 One limitation of this analysis is that as these services are not yet permissible under the 1979 Act, no credit union has yet invested to be able to offer these products. Therefore, the estimates used for this analysis rely on a small set of data, and a wide range of estimates has been provided for how much this could cost. As noted, these costs will also vary between credit unions and so some may incur a cost greater or smaller than the level estimated.

13.63 It is not possible to estimate how large these costs are likely to be, however, as mentioned earlier, credit unions will only offer these services if the benefits outweigh the costs for their own business strategies.

Ongoing costs for businesses

*Changes to credit union annual fees*

13.64 The FCA charges a fee to firms which carry out certain activities.[275] If a credit union increases the number of activities that it carries out, then the annual fee paid to the FCA will increase.

[275] The FCA fee calculator is found at Fee calculator | FCA (Rates correct as of February 2022)

13.65 Credit unions which only hold permissions for “accepting deposits” pay an annual fee of £239.62 as of February 2022.

13.66 Credit unions are currently exempt from all consumer credit annual fees, therefore offering HP/CS agreements will not impact their annual fees and it is assumed this will remain the case throughout the appraisal period. For those which will offer insurance distribution as of February 2022, there is a fee of £100 for holding the permission if firms earn up to £100,000 of insurance distribution income. There is a fee of £1.662 for every extra £1,000 earned over £100,000. There is also a small additional Financial Guidance Levy of £1.72.

*Ongoing compliance with regulation*

13.67 Credit unions will need to comply with consumer credit regulation resulting from holding the permissions for these services.

13.68 The FCA has estimated the costs of complying with consumer credit regulation, following the transfer of regulation from the OFT regime to the FCA.[276] For the consumer credit market, the transfer would create total annual costs excluding fees of between £10.3m and £20.9m for all firms offering consumer credit products such as car finance arrangements. As explained earlier, credit unions are currently exempt from all consumer credit annual fees.

13.69 The total ongoing costs to all firms from the 2013 paper are uprated to 2020 prices.[277] Therefore, the estimated costs increase from £10.3 million - £20.9 million to between £12.05 million - £24.45 million. As noted earlier, British credit unions make up 0.65% of the consumer credit firm population. Assuming costs are spread evenly across firms, 0.65% of the costs above would total between £78,325 and £158,925.

13.70 However, this cost will apply only to credit unions which choose to offer hire purchase/conditional sales agreements. As noted, the ABCUL survey highlighted that 70% of the credit union sector are interested in offering these services. Therefore, the ongoing costs to the credit union sector are expected to be 70% of the calculations above, or between £78,325 (0.65% of £12.05m) and £158,925 (0.65% of £24.45m), with a best estimate of £118,625. This would mean a compliance cost of £706.10 per year per credit union (118,625/168).

13.71 One limitation of this analysis, and the one-off costs resulting from consumer credit regulation earlier, is that these costs are calculated based on consumer credit regulation in 2013. Therefore, some of the regulation, and thus the costs, might have changed since then. The analysis is also based on estimated costs of the transfer of regulation from the OFT, meaning some costs where regulation did not change during the transfer from the OFT to the FCA may not be present. Therefore, the overall costs of regulation may be different.

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276 https://www.fca.org.uk/publication/consultation/fsa-cp13-07.pdf, page 12

13.72 The government is not aware of any updated research on the cost of the consumer credit regime. However, this research does have value, and so has been included as it shows that as the volume of regulation that credit unions have to abide by is typically fairly low, the additional costs, both permissive and regulatory, are also likely to be fairly low.

13.73 Commissioning new research into the new regulatory system could produce new, more suitable data, but this would not be proportionate to the likely impact of consumer credit regulation on credit unions and the overall impact of the measure, which is relatively low compared to the 2013 Order. The previous research was proportionate as the legislation had a greater impact on credit unions.

13.74 It is also necessary to consider any ongoing compliance costs relating to the provision of insurance distribution. As noted earlier, the IDD sets out the regulation for the distribution of insurance products.

13.75 One requirement from the IDD in FCA rules is that employees of firms must complete a minimum of 15 hours of training within a 12-month period. This helps to protect members by reducing the risk of credit unions distributing an insurance product in an improper manner and to ensure ongoing compliance with the requirements in ICOBS, including helping to assess the needs/demands of customers and complying with marketing requirements.

13.76 This will create an opportunity cost for credit unions. PRA estimated there were 1,688 members of staff employed by British credit unions as of September 2021. Larger credit unions are expected require more staff to manage the additional workload, and due to the costs in this impact assessment, they are more likely to offer insurance distribution services. PRA estimated that of the 1688 members, 49% of credit unions cover 90% (1519) of all staff.

13.77 It is therefore estimated that around 1519 staff members will need training every year. Amongst the 118 credit unions, there will be on average 12-13 staff members in each credit union who need training. Using the median hourly pay for corporate managers of £22.76 as the estimated wage for these workers, the estimated cost to each credit union for annual training is £4,096.80 (15 hours x £22.76 x 12 staff) and £4,438.20 (15 hours x £22.76 x 13 staff).

13.78 One limitation of this analysis is that all credit union staff may not go through this training. The PRA data above does not differentiate workers for this purpose, and it is not possible to make a reasonable assumption on a percentage who will need training. Therefore, the analysis assumes that all staff will need receive this training. It is not known exactly how many credit unions will take up these services, but the analysis assumes that it will be 49% in line with the ABCUL estimates, discussed above.

Transitional costs for the public sector

*Familiarisation costs for the FCA and the PRA*

13.79 As the registrar for credit unions, the FCA will need to familiarise itself with the legislation as soon as it comes into force. The PRA will also need to familiarise itself with the legislation, as the prudential regulator.

13.80 HM Treasury has been engaging with the regulators on the development of policy and drafting of the legislation. Due to this, it is expected that the FCA and PRA will already be familiar with the contents of the amendments and be prepared to consider any subsequent regulatory rule changes accordingly. HM Treasury therefore considers that the PRA and FCA would be able to absorb this within their current resourcing.

*Cost to the FCA for assessing credit unions' rule changes*

13.81 The FCA will need to assess rule changes as the registrar for credit unions. The FCA estimates it takes about three hours for an employee to assess an application from a credit union to amend their rules. The hourly median pay for a public sector professional is £20.91, so the cost of assessing a single application is approximately £62.61. The total cost to the FCA of assessing 204 (based on the earlier estimate that 86 credit unions would want to undertake HP/CS, 36 to undertake insurance distribution, and 82 to undertake both, so a total of 204) applications from credit unions to change their rules is therefore estimated to be approximately £12,797. It should be caveated that the median public sector pay figure might not be wholly representative of FCA salaries; this figure might be higher or lower depending on the salary of FCA employees. However, HM Treasury considers that the FCA should be able to absorb this with their current resourcing.

*Cost to the regulators of assessing VOP applications*

13.82 The FCA estimates that it will take an average of 30 hours to consider a VOP application for HP/CS agreements and 15 hours to assess an application for insurance distribution.[278] Using an hourly pay of £20.91, this will cost £627.30 per HP/CS sale application and £313.65 per insurance distribution application.

13.83 The total cost to the FCA for assessing HP/CS applications will be £91,585.80 (146 x £627.30), and £26,032.95 (83 x £313.65) for insurance distribution services. The total cost to the FCA is therefore £117,618.75 for assessing VOP applications. The FCA should be able to absorb this with their current headcount.

13.84 Similarly, the PRA estimates that it would take a similar length of time to the FCA for assessing VOP applications, or 30 hours to consider a VOP application for HP/CS agreements and 15 hours to assess an application for insurance distribution, and about two members of staff involved in each assessment[279]. Using an hourly pay of £20.91, this will cost £1,254.60 (£20.91*2*30) per HP/CS application and £627.30 (£20.91*2*15) per insurance distribution application.

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278 Estimate provided by the FCA

279 Estimates provided by the PRA

13.85 The total estimated cost for the PRA to assess HP/CS applications will be £183,171.60 (146 x £1254.60) and £52,065.90 (83 x £627.30). The total cost to the PRA for assessing VOP applications is £235,237.50. The PRA should be able to absorb this within their current headcount.

*Cost to the regulators of amending rulebooks to reflect consequential changes*

13.86 This legislation also includes a requirement for credit unions to submit their annual accounts to the FCA. Currently, this is set out in the FCA's Credit Union Sourcebook (CREDS)[280] as regulation rather than legislation. The FCA may want to amend CREDS to remove or adapt this requirement. The FCA may also need to update some of their forms for credit unions and may want to produce an information note alongside this.

13.87 Similarly, the PRA may want to amend or adapt their Credit Union Rulebook[281] and/or the relevant supervisory statement[282] to take into account consequential amendments from this legislation.

Ongoing costs for the public sector

13.88 No significant ongoing costs to the regulators are expected as a result of these changes. The FCA and PRA may undertake additional engagement with the credit unions that offer these new services to ensure compliance with regulation.

13.89 As the FCA and the PRA are public bodies, any estimated costs to them are not included in the EANDCB calculations.

Wider policy costs

13.90 Credit unions may compete with other providers of these services, which in turn may reduce the income of those providers.

13.91 In terms of the competition impacts on the insurance broking sector, according to FCA data there are around 10,000 personal and commercial lines insurance intermediaries. The size of the existing broking sector, relative to the number of credit unions projected to offer insurance intermediation services (118) means that any impact on the insurance brokerage market is likely to be negligible. Credit unions, as not-for-profit cooperatives with unique customer bases, may help improve access to insurance intermediation services to some consumers not traditionally as well-served by the broking market, such as consumers that struggle to access affordable financial products. More generally, greater competition in the market is expected to support improved outcomes for consumers in terms of better and lower-cost services. Due to limited data on how this legislation might impact the sector, this analysis does not attempt to calculate this impact.

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280 https://www.handbook.fca.org.uk/handbook/CREDS/8/2.html

281 https://www.prarulebook.co.uk/rulebook/Content/Part/320139

282 https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2020/ss216-update-march-2020.pdf?la=en&hash=CD32DE770B94C146F3E03637D8B0BCD8988D14AC

13.92 The ability of credit unions to offer HP/CS could mean that incumbent retail banks and Motor Finance firms see a slight decrease in lending. Again, given the size of the existing car finance and lease market, any impact on current lenders would be negligible. The Finance and Leasing Association (FLA) is the leading trade association for the motor finance sector in the UK and covers the vast majority of the car finance and lease sector. They have 162 full members, which are firms who provide finance or leasing on their own account. In 2021, FLA members had 6.2 million live contracts and £37 billion in new business in 2021 for motor finance. They estimate that 85.5% of the 737,000 new car finance agreements that year were HP/CS, while 96.8% of the 1.3 million used car finance agreements were HP/CS. They also estimate that less than 3% of the £64 billion in other forms of consumer credit provided in 2021 were HP/CS, and about 56.6% of the 2.3 million live contracts and £20 billion of new business for SME customers in asset finance were HP or equivalent[283]. The size of the existing car finance and lease sector, relative to the smaller scale of the credit union sector[284] and number of credit unions projected to offer car finance services in the form of HP/CS (168), which will operate in more limited jurisdictions given the credit union common bond, may mean that any impact on the insurance brokerage market is likely to be negligible.

13.93 Furthermore, the small reduction in revenue for incumbents is outweighed by the likely benefits to GB consumers. Evidence from the FCA notes that consumers have benefited from the intensified competition in other markets such as the residential mortgage and SME lending markets through increased choice and lower prices[285]. Due to limited data on how this legislation might impact the sector, this analysis does not attempt to calculate this impact.

**Policy Benefits**

13.94 These changes will have significant benefits for credit unions. Offering a wider range of products beyond loans will increase and diversify their income streams, making the credit union model more sustainable. As credit unions move into new products areas, it is expected that this will have a positive effect on the awareness of the credit union movement. This may lead to a multiplier effect of increased membership and income in the future. The impact of awareness is not factored into the estimates produced by this analysis due to uncertainty over the extent of this impact.

Increased income for credit unions

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283 Figures provided by the FLA directly to HMT

284 According to PRA figures, the entire GB credit union sector held just over 1.9 billion in assets and 1.4 million members in 2020 https://www.bankofengland.co.uk/statistics/credit-union/2020/2020

285 Strategic Review of Retail Banking Business Models: Final Report 2022 (fca.org.uk)

13.95 Credit unions will have increased income from their ability to offer HP/CS agreements and insurance distribution services.

*Greater income deriving from the ability to offer Hire Purchase/Conditional Sales agreements*

13.96 Credit unions will be able to offer HP/CS agreements as part of the Financial Services and Markets Bill. They will use these primarily to provide car finance. In 2020, HP/CS agreements made up 57% of the used car finance market and 11.4% of the new car finance market[286] - this was 715,482 HP/CS agreements for used cars.[287]

13.97 This analysis has been informed by engagement with the credit union sector and they have said that they are likely to predominantly focus on the used car market, as (i) car manufacturers often provide their own HP/CS agreements when consumers buy their cars, and it is unlikely that credit unions will be able to compete with these[288], and (ii) credit unions have said that offering HP/CS agreements for used cars is more likely to fit in with their "objects" as detailed above.

13.98 One limitation of this analysis is that it is difficult to estimate the market penetration rate for credit unions. The government will engage with the credit union sector once they begin offering these services to understand their market penetration and income earned from these services.

13.99 It has not been possible to monetise the benefits from this as it is not possible to anticipate when credit unions will offer these services, or how many HP/CS agreements they will sell. The decision for credit unions to offer these services will be based on commercial decisions by individual credit unions and they will only offer them if they believe that the benefits will outweigh the costs.

*Greater income deriving from the ability to offer Insurance Distribution Services*

13.100 As noted above it has been estimated that 118 credit unions, or 49% of GB credit unions, will offer insurance distribution services. It is likely that larger credit unions will have greater capability to offer these services, meaning that a larger percentage of credit union members will be represented by credit unions that will offer the services.[289]

13.101 Insurance premiums may vary significantly depending on several factors, including the type of policy taken out, duration and risk. The FCA does not currently capture or

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[286] https://www.fla.org.uk/research/motor-finance-key-statistics/

[287] Loans and HP/CS agreements are not split up in the publicly available data for new cars

[288] https://www.fla.org.uk/research/motor-finance-key-statistics/

[289] A small number of credit unions make up a significant proportion of the membership. For example, statistics provided by the National Credit Union Forum, which represents seven large credit unions, shows they represent roughly 225,000 members. This means 3% of GB credit unions represent over 16% of the membership base. The 2019 PRA consultation on amendments to credit unions capital regime also demonstrated that there is a "long tail" of smaller credit unions. It is worth noting that their numbers are UK wide and based on 2019 data.

publish premium data.[290] Data on average insurance policy premiums for a wide variety of products is not publicly available but limited public data from the Association of British Insurers is available. This notes that the average premiums for motor and domestic property insurance (buildings and contents combined) were £471 and £313 respectively in 2019.[291] In 2019, the average pet insurance premium was £271.[292] Based on these averages and potential variation, it has been assumed for the purposes of this impact assessment that insurance premiums would be between £250-£500.

13.102 Based on data from the FCA, for the purposes of this Impact Assessment it is assumed that credit unions receive a commission of 25-60% from the insurance company.[293] This will vary depending on relationship with the insurance company and the type of insurance they are broking.

13.103 It has not been possible to estimate the overall costs for this as it has not been possible to estimate how many insurance distribution services credit unions will be able to sell. Additionally, the figures given above are illustrative and are based on estimates following engagement with the industry and publicly available data.

*Increased awareness of credit unions among consumers*

13.104 In addition to generating additional income, credit unions offering these additional products and services may increase awareness of credit unions among consumers. These consumers may then utilise credit unions' existing loan products, creating further income for those credit unions. The likely impact of this is difficult to assess and thus no monetised estimate has been made.

*Allowing credit unions to borrow from other credit unions*

13.105 This will explicitly allow credit unions to temporarily borrow from and lend to other credit unions, regardless of a membership link. This is intended to provide legal clarity for credit unions on an already existing activity and so this is not expected to have a material cost for credit unions. Assessing potential use of this mechanism and the impact on credit union lending would require us to survey the whole sector and would depend on credit unions' financial position at a particular time which is difficult to predict.

Benefits to consumers

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290 Time of writing February 2022.

291 https://www.abi.org.uk/globalassets/files/publications/public/key-facts/abi_key_facts_2021.pdf

292 https://www.abi.org.uk/news/news-articles/2020/04/covid-19--pet-insurers-agree-commitments-to-reassure-britains-7.7-million-pet-insurance-customers/

293 Commission levels are commercially sensitive and thus are not generally publicly available. The FCA has published thematic reports on insurance distribution previously, such as TR19/2, which provide some indicative commission levels that are charged in industry, but these may vary between insurance products distributed.

13.106 The FCA has classed credit unions as an alternative to high-cost credit,[294] as their interest rates are capped at 3% per month (42.6% APR). This is substantially lower than high-cost lenders.[295]

13.107 Allowing credit unions to offer a wider range of products and services will increase the income which the credit union sector earns. This in turn will provide greater opportunities for credit unions to invest in their growth and ability to provide products for their members, such as affordable loans. This, combined with greater awareness of the credit union model, may help credit unions reach new customers who might otherwise have gone to high-cost lenders that were possibly unsuited the members' needs or financial situations, thereby increasing financial inclusion.

13.108 This measure will also support members' financial resilience. In highlighting specific insurance products to their members which they feel will benefit their needs, members may be more likely to take out products such as contents insurance, which will help cover them in an emergency and help them avoid using their own savings or take out credit to cover the costs. Additionally, attracting new members and offering additional products and services may allow credit unions to pay a greater dividend to their members on their savings[296], as they pass the benefits of greater income back to their members, further increasing their financial resilience.

**Assumptions, limitations, and considerations**

13.109 Most of the analysis in this assessment draws on data from an ABCUL survey and associated town hall events. Some respondents to this survey may not end up adopting the new products and services, so the actual costs and benefits may differ from the estimates provided due to uncertainty surrounding some of the assumptions made in the assessment. In particular, credit unions do not currently offer these products and services at scale[297] and have wide-ranging levels of existing capability, which has made it challenging to estimate the costs credit unions will incur. However, the Government has engaged with the credit union sector and the FCA and PRA to ensure that estimates used are based on the best possible evidence available and will engage with the sector following the introduction of this legislation on the costs incurred by the sector.

13.110 Some of the analysis draws on estimates produced by a small part of the credit union sector. Whilst analysis has come from credit unions of varying sizes, costs and income may vary significantly within the sector, meaning some of the actual costs and benefits may differ from the estimates.

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[294] https://www.fca.org.uk/publication/research/alternatives-high-cost-credit-report.pdf

[295] High-cost lenders typically have a cap of 0.8% per day, with a total cost cap of 100% of the amount borrowed. This would be reached in 125 days.

[296] Typically, credit unions reward their savers through a dividend at the end of each year. This level of this dividend depends on the performance and income of the credit union each year.

[297] Whilst some credit unions offer limited insurance distribution services, given the small number, the data provided may not have been appropriate.

13.111 Furthermore, the analysis has not differentiated between the different size of credit unions. Some credit unions may earn more or less than the estimates provided.

13.112 Finally, it has been assumed that credit unions' business models will continue as at present for the duration of the assessment period and their membership levels remain constant. The changes in their activities could be driven by wide-ranging and unpredictable factors which may alter the firms' associated costs and present a potential risk to the assumptions made in this analysis.

**Small and MicroBusiness Assessment (SaMBA)**

Number and distribution of businesses in scope of the regulation

13.113 According to data provided by the PRA, all credit unions in Great Britain (GB) have fewer than 50 members of staff, meaning that they are all classed as SMBs. HM Treasury has used this definition throughout the SaMBA, where data is available. At the time of writing, the PRA estimates there are 240 credit unions in Great Britain[298], meaning there are 240 SMBs in scope of the regulation.

13.114 The new, optional object for credit unions to be able to offer HP/CS agreements and insurance distribution services is permissive, so not all credit unions will choose to adopt this. Furthermore, not all of the credit unions interested in offering HP/CS agreements and/or insurance distribution services may immediately be capable to do so. For example, credit unions will need to obtain the relevant regulatory permissions, amend their rules, and invest in their capacity to be able to offer the new services, which will inevitably take time.

13.115 Results from ABCUL's 2019 consultation showed that 70% of credit unions who responded indicated that they wanted to offer car financing in the form of HP/CS, and 49% of respondents wanted to offer insurance distribution services. In the absence of any additional data, these are taken to be the best estimate of the number of credit unions which will decide to offer these services. Therefore, it is anticipated that these changes will lead to 168 credit unions offering car finance services in the form of HP/CS (70% of the 240 total), and 118 credit unions offering insurance distribution services (49% of the 240 total).

Do the impacts fall disproportionately on small and microbusinesses?

13.116 As set out above, all credit unions in Great Britain have fewer than 50 members of staff, meaning that they are all classed as SMBs. This means that all credit unions, and only SMBs, are in scope of these changes. There are no credit unions that are medium or large businesses against which to consider the impact. Some credit unions do offer corporate accounts. ABCUL has provided details that 62 of their members offer, in total, about 1400 corporate accounts, and that most of these are transactional accounts rather than lending. There is limited data to estimate how many of these might be classified as SMBs, so this impact has not been calculated.

*Additional products and services*

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298 https://www.bankofengland.co.uk/statistics/credit-union/2020/2020

13.117 Most of the legislative changes are permissive; credit unions will choose whether or not to offer the additional products and services (hire purchase agreements, conditional sale agreements, insurance distribution services, and lending to or borrowing from other credit unions). The government assumes that they will only do so if they decide it is the right business decision for their organisation, meaning any negative impacts such as costs should only be incurred should the credit unions choose to take up these products and services, and therefore would not be disproportionate.

13.118 Equally, there should not be any disproportionate benefits for credit unions who take on these products and services. If they choose to adopt the new, optional object, they will all be required to follow the same regulation as any other financial services provider offering these products.

13.119 If credit unions choose not to adopt the new, optional object, then no additional regulation will be imposed, and there is not an expectation that additional costs to be incurred beyond the initial familiarisation costs.

*Impact on the sector*

13.120 These changes will have significant benefits for credit unions (all of which are SMBs) who choose to take on the new, optional object to offer HP/CS agreements and insurance distribution services. Offering a wider range of products beyond loans will increase and diversify credit unions' income streams, making their business model more sustainable. As credit unions move into new product areas, it is expected that this will have a positive effect on the awareness of the mutual movement and more choice for consumers. This may lead to a multiplier effect of increased membership, and therefore income, in the future.

*Submitting accounts to the FCA*

13.121 The requirement to submit annual accounts to the FCA will apply to all credit unions and, in turn, all SMBs within scope since all credit unions are SMBs. As explained earlier in this assessment, credit unions do not currently need to submit annual accounts to the FCA in its capacity as registrar for credit unions under legislation. However, the FCA has already required credit unions to submit annual accounts to the FCA through their Credit Unions Sourcebook, which are rules created by the FCA. Credit unions are also already required to submit regulatory returns to the PRA on at least a quarterly basis. The government therefore does not believe this will create additional costs for credit unions as SMBs.

Could small and microbusinesses be exempted from the policy objectives?

13.122 The department does not consider that an exemption would be appropriate for SMBs. This is because all credit unions in Great Britain have fewer than 50 members of staff, meaning that they are all classed as SMBs. It would therefore not make sense to exempt affected SMBs from the relevant changes to the Credit Unions Act.

Furthermore, the new, optional object is permissive, so if credit unions (SMBs) do not wish to take on the additional products and services, then they are largely unaffected.

13.123 The only requirement that will impact all credit unions is the new legal requirement to submit annual accounts to the FCA. All credit unions (SMBs) are already required by FCA rules to submit annual accounts by the FCA's rules, so the new legal requirement should not place undue burden on credit unions as it is something they already do. Additionally, submitting annual accounts to the regulator is part of good governance structures, so it would not be appropriate to exempt credit unions from this requirement.

Could the impact on small and microbusinesses be mitigated while achieving the policy objectives?

13.124 The legislation mitigates costs to credit unions (SMBs) which do not want to take on the additional products and services by virtue of being permissive. Credit unions choose whether they wish to take on the new products and services andit is assumed that a credit union will only take these on if it decides it would benefit their business strategy. Credit unions which do not want to offer the new products and services will be unaffected.

Wider impacts on small and microbusinesses

13.125 The measure could potentially displace business activity in insurance distribution markets as credit unions start to offer new products. According to the FCA, there are around 10,000 personal and commercial lines insurance intermediaries. There is insufficient data held about the sector to determine whether any of these intermediaries are small or micro businesses in terms of either employee numbers, balance sheet size, or turnover, so the impact on small and microbusinesses in this sector cannot be calculated. Any displacement would likely be in favour of credit unions, all of which are SMBs – and therefore, any impact of this displacement would be expected to be either neutral or positive in respect of the total impact on SMBs.

13.126 In terms of displacing business activity in HP/CS markets for small lenders, there are 162 full members of the Financing and Leasing Association (FLA), i.e., firms who provide finance or leasing on their own account. The FLA has confirmed that all motor and asset finance members provide HP/CS. Although the FLA does not hold exact data, they have estimated that around 40% of FLA members are SMEs. Of course, this figure may take into account businesses which are above the SMB threshold. The size of the existing SMB car finance and lease sector, relative to the number of credit unions projected to offer car finance services in the form of HP/CS (168), means that any displacement is likely to be relatively minimal when compared to the market as a whole.

13.127 Furthermore, credit unions offering HP/CS agreements could displace business activity in the high-cost credit market. According to a 2018 consultation paper

conducted by the FCA[299], there were around 20 firms in the 'rent-to-own' market, which provide products similar to HP agreements, and may currently be used to support consumers in purchasing items such as white goods.[300] However, the largest firms have since left the market, with the remaining firms each holding balances below £3 million and new lending of less than £2 million per year[301], making them all small-to-medium sized enterprises (SMEs). This impact assessment estimates that 168 credit unions could choose to offer these agreements, in which case credit unions offering these products could disrupt this high-cost credit market. However, credit unions operate in specific consumer markets, only providing products for members that live and work in their common bonds. Credit unions also have a statutory cap on the interest they can charge on their loans, which stands at up to 3%. The legislation makes a provision to cap hire purchase agreements and conditional sale agreements at the same rate. Due to a lack of data on the markets these high-cost credit lenders operate in, it is difficult to confidently estimate the potential displacement impacts on these SME high-cost lenders.

13.128 Credit unions, as regulated and not-for-profit financial cooperatives with unique customer bases, may help provide access to insurance intermediation services and HP/CS agreements to some GB consumers not traditionally served by the SMB broking and car finance and lease markets, such as consumers who struggle to access affordable financial products. More generally, HM Treasury expects greater competition in these markets to support improved outcomes for consumers in terms of better and lower-cost services. Due to limited data on how this legislation might impact the sector, this analysis does not attempt to calculate this impact.

13.129 The small reduction in revenue for SMB incumbents is outweighed by the likely benefits to GB consumers. Evidence from the FCA notes that consumers have benefited from the intensified competition in other markets such as the residential mortgage and SME lending markets through increased choice and lower prices[302]. Due to limited data on how this legislation might impact the sector, this analysis does not attempt to calculate this impact.

13.130 Throughout this assessment, it should be made clear that this legislation only impacts credit unions in GB, and therefore only GB consumers and markets. The total costs above in terms of wider impact has not been scaled to account for only GB due to limited data on firm locations.

**Monitoring and Evaluation**

13.131 As part of their monitoring of the conduct and stability of the credit union sector, the FCA and PRA will be able to monitor the take up of the new services and the benefits they are providing to the sector. HM Treasury is also committed to monitoring new

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299 CP18/35: Rent-to-own and alternatives to high-cost credit – feedback on CP18/12 and consultation on a price cap (fca.org.uk)

300 usage-and-experiences-of-high-cost-credit-consumer-research-report.pdf (fca.org.uk)

301 CP18/35: Rent-to-own and alternatives to high-cost credit – feedback on CP18/12 and consultation on a price cap (fca.org.uk) pg. 59

302 Strategic Review of Retail Banking Business Models: Final Report 2022 (fca.org.uk)

service take up in regular stakeholder engagement with the regulators and the credit union sector. This will include engagement over the income earned and costs incurred from credit unions offering the new services. HM Treasury will engage with the credit union sector and the FCA to ensure no disproportionate costs arise from the requirement to submit annual accounts.

## Liability of payment service providers for fraudulent transactions

**Problem under consideration**

14.1 Total losses due to authorised push payment (APP) scams increased to £583.2 million in 2021, up 39 per cent compared to 2020.[303] The number of cases rose 27 per cent to 195,996. In the past the largest fraud losses were on payment cards, however criminals are increasingly focusing on authorised push payment[304] (APP) fraud where customers are tricked into authorising a payment to an account controlled by a criminal.

14.2 APP scams can broadly take two forms:

a. 'Malicious payee' fraud. This is where victims make a payment for what they believe are legitimate purposes (typically in return for promised goods or services), but those goods or services then do not exist. Examples of malicious payee fraud include investment scams and advance fee scams.

b. 'Malicious redirection' fraud. This is where victims believe they are paying a known or legitimate payee but are instead tricked into making a payment into a fraudster's account. This type of fraud includes interception scams, where a legitimate request for payment is intercepted and the details of the payee changed; and impersonation scams, where a fraudster contacts the victim claiming to be from a trusted organisation (e.g. the police or the victim's bank) and requests payment to an account they control.

14.3 In 2016, the consumer advocacy group Which? made a 'supercomplaint' in respect of APP scams to the PSR, the statutory regulator for payment systems in the UK.[305] Which? was concerned that there is not an appropriate level of consumer protection in cases of APP scams, compared to other types of payment. The PSR responded to their complaint and has since taken forward a programme of work, both to prevent these scams, but also to ensure improved outcomes for scam victims.

14.4 The PSR worked with payment service providers (PSPs – authorised firms that make and receive payments on behalf of payers, such as banks) to develop the Contingent Reimbursement Model (CRM) Code ("the Code"), which began operating in 2019, by which payment service providers voluntarily reimburse APP scam victims. The Code

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303 https://www.ukfinance.org.uk/system/files/2022-06/Annual%20Fraud%20Report%202022_FINAL_.pdf

304 A "push payment" is made when someone authorises their payment service provider, typically a retail bank, to send money to a payee's account. In an authorised push payment scam, someone is deceived into making a push payment to a criminal.

305 Certain representative bodies can make super-complaints to the PSR if they believe that features of the payment systems market are, or appear to be, significantly damaging to the interests of service-users.

has been signed by ten banking groups (comprising 21 banking brands), who collectively account for around 90% of Faster Payment[306] transactions in the UK.[307]

14.5 Not all participants in Faster Payments have signed up to the Code, or have any other commitment to APP scam reimbursement, and so some APP scam victims remain unprotected by reimbursement commitments. Furthermore, even amongst signatories to the Code, the level of reimbursement/repatriation under the Code is less than 50% of total APP scam losses[308], with wide disparities between different signatories, and high numbers of complaints to the Financial Ombudsman Service regarding how signatories are interpreting their obligations under the Code. The lack of reimbursement liability across all providers, alongside the inconsistency with which providers interpret their obligations, results in unequal consumer protection and poor reimbursement outcomes. Personal losses can amount to thousands of pounds, and victims are often from already-vulnerable groups (especially the elderly).

14.6 The current situation is unsatisfactory as personal financial losses to fraud regularly exceed thousands of pounds, and many victims receive little to no reimbursement. The PSR issued a Call for Views in February 2021[309], seeking views on whether to make reimbursement for APP scam victims which occur over Faster Payments mandatory, and consulted on this question in November 2021.[310] In doing so, they identified a barrier in the Payment Services Regulations 2017 which prevent the PSR from using its existing regulatory powers (including powers of direction, and to make system rules), to introduce mandatory APP scam reimbursement for scams which occur over Faster Payments.

14.7 According to UK Finance data[311], the Faster Payments system was used in ~97% of APP scams by volume in 2021 – see Table 1. Therefore, it is the government's view that PSR action to introduce mandatory reimbursement requirements in Faster Payments would substantially improve reimbursement rates in cases of APP fraud, and subsequently lead to better outcomes for victims of APP scams. The Economic Secretary therefore made a statement in November 2021 that the government would address any legislative barriers to PSR regulatory action on APP scam reimbursement when parliamentary time allows – which is the focus of this legislative measure.

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306 The Faster Payments Service (FPS) is the UK's main low-value real-time payment system. It is used for the majority of consumer bank transfers, and is therefore the payment system over which most APP fraud occurs.

307 https://committees.parliament.uk/writtenevidence/108066/html/

308 https://www.psr.org.uk/media/kg0bx5v3/psr-cp21-10-app-scams-consultation-paper-nov-2021.pdf

309 www.psr.org.uk/publications/consultations/cp21-3-authorised-push-payment-scams-call-for-views/

310 https://www.psr.org.uk/media/kg0bx5v3/psr-cp21-10-app-scams-consultation-paper-nov-2021.pdf

311 www.ukfinance.org.uk/system/files/Fraud%20The%20Facts%202021-%20FINAL.pdf

Table 15.A: Number & value of APP scam transactions in 2020 and 2021, UK Finance

| | 2020 | | 2021 | |
|---|---|---|---|---|
| **Payment Type** | Value | Number | Value | Number |
| **Faster Payment** | £349.4m | 236,641 | £504.5m | 335,451 |
| **CHAPS** | £14.5m | 501 | £22.5m | 764 |
| **BACS** | £23.5m | 1193 | £20.4m | 1695 |
| **"On us" (intra bank transfer)** | £10.6m | 3113 | £7.5m | 3358 |
| **International** | £22.7m | 3123 | £28.3m | 3869 |
| ***Total*** | £420.7m | 244,571 | £583.2m | 345,137 |

**Rationale for intervention**

14.8 Payment services in the UK are primarily regulated under the Payment Services Regulations 2017 (PS Regs). The PS Regs establish the rights and obligations of payers/payees and payment services providers in relation to payment services. Aside from some exceptions, the PS Regs apply to anyone who is a payment service provider (i.e. any authorised or exempt entity that provides a payment service as a regular occupation or business activity in the UK).

14.9 The PS Regs already offer protections for payment service users in cases of unauthorised payments (where the payer has not authorised the payment, for example where a payment card is stolen), typically resulting in reimbursement by the payment service provider. Under the current legislative and regulatory framework, payment service providers are not required to reimburse victims of an APP scam, regardless of the fact that the victim has been defrauded. Personal financial losses for victims of an APP scam can therefore be significant.

14.10 Regulation 90 of the PS Regs concerns liability on payment service providers in relation to payment orders. Currently, where a payment is correctly completed by a PSP with a unique identifier (typically a sort code and account number) provided by its customer when authorising the payment, a payment service provider is not liable to reimburse the customer. This means that payment service providers are not liable to reimburse someone who has been defrauded into making a payment, if they correctly transfer funds in line with the account details they have provided.

14.11 In the assessment of HM Treasury and the PSR, Regulation 90 has been identified as the barrier to the PSR using its powers under the Financial Services (Banking Reform) Act 2013 (FSBRA) to introduce mandatory reimbursement for APP scams across Faster Payments. Without this barrier, the PSR would use its powers to direct Pay.UK, the operator of the Faster Payments, to introduce new rules and requirements on participants in Faster Payments (namely banks and other payment service providers). The Bill will therefore amend Regulation 90, to make clear that it does not prevent the PSR from using its existing FSBRA regulatory powers to introduce reimbursement, in cases where a payment has been authorised as a result of fraud. Removing the barrier posed by Regulation 90 also enables the PSR to act

with respect of other designated payment systems, where risks to consumers may apply and/or could increase over time.

**Policy Objective**

14.12 The legislation will clarify that the PSR can use its existing FSBRA powers to require reimbursement in relation to APP scams, via an amendment to Regulation 90 of the PS Regs, enabling the PSR to introduce mandatory reimbursement for APP scam victims in designated payment systems.

14.13 Additionally, the Bill will also introduce a Duty on the PSR, requiring them to consult on a draft regulatory requirement on APP scam reimbursement within a specified timeframe (2 months), and to issue the Direction within a second specified timeframe (6 months), for the Faster Payments System specifically. This will ensure prompt PSR action following the legislative change.

14.14 Together with the Duty, the ultimate policy objective is for the PSR to introduce a mandatory reimbursement model for Faster Payments, as set out in the PSR's Consultation on APP scams. The expectation is that this would result in more comprehensive and consistent reimbursement for APP scam victims, with a greater proportion of APP scam victims receiving reimbursement.

14.15 Removing the barrier posed by Regulation 90 also enables the PSR to act with respect of other designated payment systems, where risks to consumers may apply and/or could increase over time.

**Description of Options Considered**

14.16 Option 0 (Do nothing) - Taking no action on this matter is unlikely to change the percentage of APP scam losses which are reimbursed, which means that the government will not meet its objective of providing further protections to victims of APP scams. This will be the case for several reasons:

a. Payment service providers are disincentivised from adopting generous reimbursement policies if their competitors do not.

b. The six largest banking groups are already signatory to the CRM Code, and most APP scam payments are sent from customer accounts with the six largest banking groups.

c. The extent of reimbursement under the current CRM Code (approximately 50%) has remained a relatively stable figure since its inception.

14.17 As losses to APP fraud are increasing year-on-year[312], taking no action would likely result in a continued increase in personal losses to APP scams. In addition, due to differing interpretations of the voluntary CRM Code, taking no action would likely result in continued inconsistency in the individual approaches of payment service providers. This would mean payment service users would continue to experience varied degrees of protection. Equally, with approximately 10% of UK faster payment

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312 https://www.ukfinance.org.uk/system/files/Fraud%20The%20Facts%202021-%20FINAL.pdf

transactions facilitated through payment service providers not party to the CRM, many customers could continue to receive little to no protection at all.

14.18 Option 1 (Preferred Option) - Amend Regulation 90 of the PS Regs to enable the PSR to introduce APP scam reimbursement and a Duty using its existing FSBRA powers.

**Outline of preferred policy**

14.19 This measure will clarify within Regulation 90 of the PS Regs that the PSR may use its existing FSBRA powers to introduce mandatory reimbursement for APP scams. The amendments to Regulation 90 of the PS Regs will be targeted to ensure that the existing protections that are offered to payment users are preserved. This includes requirements on payment service providers to help a customer recover misdirected funds, including in some APP scams.

14.20 The practical implementation of APP scam reimbursement will be dependent on how the PSR uses its powers to mandate APP scam reimbursement, alongside how Pay.UK, the payment system operator of Faster Payments, subsequently implements, monitors, and enforces the requirement. The PSR is currently consulting on the exact nature of their potential policy to mandate reimbursement, and a Duty will be introduced to give clarity and ensure the PSR takes regulatory action to mandate reimbursement once this legislative change is made. The final form of the PSR's regulatory approach will be published following further consultation by the PSR, and within the timescale set out by the Duty.[313]

**Methodology**

14.21 This measure has been assessed against the counterfactual of option 0 as set out above – do nothing.

14.22 HM Treasury will introduce a Duty on the PSR to take regulatory action to a specified timescales following this legislation, this analysis sets out what the expected costs and benefits, noting that these will ultimately be dependent on the exact nature of the action PSR takes.

14.23 The PSR is required by law to publicly consult on draft directions and requirements, including publishing a draft of the direction or requirement. It is expected that a full Cost Benefit Analysis will be published by the PSR alongside its public consultation, and before it uses its powers to introduce mandatory APP scam reimbursement.

14.24 The assessments of costs and benefits below uses:

a. publicly available information provided by the PSR

b. public information provided by UK Finance in relation to APP scams.

14.25 HM Treasury is not aware of a reimbursement mandate existing in any other country in relation to Authorised Push Payment (APP) fraud. As such, comparisons or predictions using data drawn from the policies of other countries are not possible. Some jurisdictions are in the process of reviewing consumer harms due to APP

313 https://www.psr.org.uk/media/kg0bx5v3/psr-cp21-10-app-scams-consultation-paper-nov-2021.pdf

scams, namely the European Commission as part of its review of the Payment Services Directive 2 (PSD2)[314]. However, this review remains in an evidence-gathering phase, and has not yet materialised as policy.

**Policy Costs**

14.26 The measure enables the PSR to use its regulatory powers to introduce mandatory reimbursement in designated payment systems in the instances of APP scams.

14.27 Any further costs or benefits arising from this measure will be dependent on how the PSR takes forward the implementation of the reimbursement requirement.

Transitional costs

*Familiarisation Costs*

14.28 Should the PSR mandate a new rule in Faster Payments, Pay.UK will incur some administrative costs relating to the implementation of the new rule. These are likely to be mainly comprised of I.T. and staff-related costs. Payment service providers will also experience one-off familiarisation and administrative costs in order to establish corporate resources to manage the new rules. This is likely to include recruiting and/or training new staff to investigate cases under new guidance relating to the new regulation. However, to the extent that many PSPs are already CRM participants, these costs are not expected to be substantial.

Ongoing costs

*Reimbursement Costs*

14.29 Following PSR regulatory action, payment service providers would face ongoing costs, the most significant of which would be the cost of reimbursing victims of an APP scam fraud.

14.30 One approach to estimating the ongoing cost of reimbursement for payment service providers is to use the current financial losses to APP Scam fraud through Faster Payments (£583.2m for 2021, as reported by UK Finance[315]), and the current level of reimbursement (~46.5% in 2021 amongst Code signatory banks[316]). Assuming that payment service providers reimburse at significantly higher levels than currently, this could have resulted in additional costs to payment service providers, and transfers to APP scam victims, of the magnitude of ~£312m (53.5% of £583.2m, assuming all APP scam cases are reimbursed).

14.31 As has been noted above, APP scams have continued to increase in volume and value in recent years. Given this trend, it is a reasonable assumption that costs of reimbursement to victims of APP scams would continue to increase in the short term. However, the magnitude of this increase is difficult to predict, as many factors

314 https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52020DC0592

315 https://www.ukfinance.org.uk/system/files/2022-06/Annual%20Fraud%20Report%202022_FINAL_.pdf

316 https://www.ukfinance.org.uk/system/files/2022-06/Annual%20Fraud%20Report%202022_FINAL_.pdf

influence the volume and value of APP scams, such as changing behaviour by fraudsters and consumers, and the impact of measures in preventing payments fraud taken by banks which are currently being rolled out (such as Confirmation of Payee, where a customer can check the name of the payee they are sending money to). Moreover, future trends in APP fraud may also be impacted by the other (non-reimbursement) measures to combat APP scams outlined by the PSR in its Consultation, including improved prevention through enhanced data sharing. In the medium term, as consumer awareness and fraud prevention measures continue to take effect, it is plausible that the value of scams could fall, reducing the cost of this measure.

14.32 This total financial burden would be unequally divided between different payment service providers, according to the levels of fraud each provider facilitates. The burden of reimbursement for each individual payment service provider is expected to be approximately proportionate to the number of fraudulent transactions they facilitate. Currently there is no published data on total scams by payment service providers; however, the PSR is consulting on measures to publish this data in future.

14.33 It has been suggested that in the event of mandatory reimbursement for APP scams, payers may take less care when transacting, in the knowledge that they will be reimbursed should they be defrauded through an APP scam, hence fraud levels might increase. However, in its most recent consultation, the PSR states it has seen no compelling evidence to suggest that mandatory reimbursement will cause customers to be more careless with their payments. The PSR also recognise some anecdotal evidence from PSPs with blanket victim reimbursement policies, suggesting that their claims did not increase upon introduction of a full reimbursement policy.

*Administrative and fraud prevention costs*

14.34 Alongside the cost of reimbursement itself, payment service providers could experience ongoing additional administrative costs to process reimbursement requests from APP scam victims. However, to the extent that payment service providers already investigate claims, there should not be a material increase in the costs as a result of this measure.

14.35 A requirement to reimburse consumers would incentivise payment service providers to invest in fraud prevention in order to minimise the amount of reimbursement they are liable for. Payment service providers have existing programmes to promote fraud prevention and consumer education; however this measure is expected to increase payment service providers' efforts to promote prevention as a result of a reimbursement requirement.

14.36 In doing so, there may be an increase in costs to payment service providers as a result of enhanced additional anti-fraud measures. It is not possible to accurately quantify the ongoing cost to PSPs of improving their anti-fraud capabilities. However, the PSR has produced a CBA of the additional cost to payment service providers of the introduction of the 'Confirmation of Payee' (CoP) system for Directed payment

service providers to combat fraud[317]. The PSR estimated total capital expenditure across the payment service providers as £45 million, with total running costs of £1.8 million per year thereafter. The CBA indicates that implementing new anti-fraud systems, as payment service providers may increasingly do following the implementation of a reimbursement requirement, may have significantly lower annual ongoing costs than one-off costs, given the costs involved in anti-fraud innovation (including programming costs, cyber security, familiarisation, and ensuring interoperability, amongst others). However, given that this represents the total cost of rolling out an entirely new system like CoP, rather than the *additional* spend that payment service providers may be incentivised to make in response to increased reimbursement, this comparison is limited.

14.37 As improved fraud prevention could reduce the value and volume of scams, and hence the liability on PSPs to reimburse victims of APP fraud, overall costs from fraud could fall over time, including for reimbursement.

**Policy Benefits**

14.38 The measure ensures the PSR will use its regulatory powers to introduce mandatory reimbursement in designated payment systems in the instances of APP scams.

14.39 The further benefits arising from this measure will be dependent on how the PSR takes forward the implementation of a reimbursement requirement.

*Consumer protection*

14.40 A reimbursement mandate would provide significantly more protection to the overwhelming majority of APP scam victims, whose payment was made through the Faster Payments system. As noted previously, the estimate for annual additional reimbursement costs for PSPs is the same as the estimate of additional reimbursement benefits for APP scam victims, given that a reimbursement mandate would require PSPs to reimburse the total sum a victim has lost. Based on the methodology outlined in the preceding paragraphs, the upper-bound estimate of additional reimbursement to victims could have totalled ~£312m in 2021.

14.41 A reimbursement mandate is especially beneficial for those who are not covered at all by the existing CRM, but also for those who may fail to meet the reimbursement requirements of their individual PSP’s interpretation of CRM Code. Greater consistency between PSPs on reimbursement policy ensures victims will receive the same level of robust protection regardless of their PSP, hence greater consistency in reimbursement outcomes. The large variation in reimbursement rates among code signatories suggests that there is significant scope for some PSPs to improve their rates. For example, according to the PSR’s Call for Views on APP scams, in Q4 2020, the rate of reimbursement and repatriation among the nine signatories ranged from around 30% to 76% of APP losses assessed under the CRM Code. Large discrepancies

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317 https://www.psr.org.uk/media/a41lz5ol/psr-cp-21-11-cop-dual-running-december-2021.pdf

were also reflected across the whole of 2020, with annual averages for PSPs ranging from 18% to 64%.[318]

*Fraud prevention*

14.42 As set out above, another significant impact of a PSR reimbursement mandate would be to enhance incentives to PSPs to invest in fraud prevention, thus reducing APP fraud levels overall. As such, the costs of reimbursement to PSPs might then fall over time. This is challenging to quantify at this stage, as this will depend on several factors including the exact form which the PSR reimbursement mandate would take.

**Assumptions, limitations, and considerations**

14.43 The CRM Code came into force in 2019, meaning data prior to 2019 is not used for purposes of comparison to a "Do Nothing" scenario. Therefore, a quantitative estimate for future changes in levels of APP scams can only be based on a single full year of data at this stage, and thus cannot be accurately predicted.

14.44 The reported level of APP fraud is likely to be below the true figure[319], hence if reimbursement was mandated and levels of reporting increased as a result, PSPs may experience higher-than-expected ongoing reimbursement costs.

14.45 It is not possible to accurately predict whether the change in reimbursement policy would affect annual losses to APP scams. For instance, whether PSP customers may take less care when transacting in the knowledge that they will be reimbursed should they be defrauded through an APP scam.

14.46 There is no data available on the rates of reimbursement versus repatriation. This is important for any quantitative calculation of cost to PSPs, as repatriation does not require PSPs to make up the losses themselves.

**Small and Microbusiness Assessment (SaMBA)**

Number and distribution of businesses in scope of the regulation

14.47 Although there are no small or micro businesses that participate directly in Faster Payments, there are some PSPs with indirect access[320] to Faster Payments that are likely to qualify as a small/micro businesses, and to whom a future reimbursement requirement could feasibly apply if required by the PSR.

14.48 HM Treasury, and the regulatory authorities, do not have data regarding the number of individuals employed by PSPs that would be needed to form an accurate assessment of the costs for SMBs in their strict definition, based on employee count.

318 https://www.psr.org.uk/media/5yvpidyc/psr_cp21-3_app_scams_call_for_views_feb-2021.pdf

319 1.6 at https://www.psr.org.uk/media/kg0bx5v3/psr-cp21-10-app-scams-consultation-paper-nov-2021.pdf

320 Many major payment service providers (PSPs) are direct participants in Faster Payments, meaning they have direct access to the system. 'Indirect access' refers to a PSP that can access Faster Payments through a commercial arrangement with another PSP that has direct access. Due to the costs involved in direct participation, directly connecting to Faster Payments is often not commercially viable for smaller PSPs with lower volumes of payments, for whom it is cheaper to connect indirectly through a sponsoring PSP (which performs Bank of England Settlement on their behalf).

However, as a proxy, it is possible to instead focus on two types of PSP that HM Treasury expects are more likely to class as SMBs: registered small payment institutions (SPIs) and small electronic money institutions (SEMIs).

14.49 These are two sub-categories of payment service provider created under the Payment Services Regulations 2017 and Electronic Money Regulations 2011 specifically to cater for smaller businesses, and which provides for a lower regulatory burden commensurate to the scale of the business.

14.50 There are 559 registered small payment institutions in the UK, and 34 small electronic money institutions (henceforth referred to as small PSPs). In sum, these 593 PSPs represent 39% of the total number of PSPs regulated by the FCA (1,505). [321] This data is available as a result of the legislative requirement for such businesses to register with the FCA in order to provide their services. These firms are, by definition, smaller entities, as defined in the legislation with particular reference to an upper limit on payment transaction volumes (rather than employee count). In particular:

a. For a small payment institution, the monthly average value of the total payments the business may facilitate must be lower than 3 million euros (~£2,531,000 GBP) over the 12-month period preceding application for registration;

b. For an electronic money institution:

   - Likewise, the monthly average value of the total payments the business may facilitate must be lower than 3 million euros (~£2,531,000 GBP) over the 12-month period preceding application for registration;
   - The total business activities of the applicant immediately before the time of registration must not generate average outstanding electronic money that exceeds 5,000,000 euro (~£4,206,000 GBP).

14.51 The conditions to qualify for a small payment institution or small electronic money (e-money) institution can be found in Regulation 14 and Regulation 13 of the Payment Services Regulations 2017 and Electronic Money Regulations 2011, respectively.

14.52 While HM Treasury considers small payment and e-money institutions the best available alternative data to use in this estimation, it expects that small (and certainly micro-) businesses, when defined in the strict definition using employee count rather than in the above FCA-defined sense, are unlikely to facilitate as much as £2,531,000 of payments every month. Therefore, the definition of a small payment institution and small electronic money institution is likely to comprise a number of firms well above the threshold to qualify as an SMB.

Do the impacts fall disproportionately on small and microbusinesses?

[321] FCA source. See the following address for background on SPIs/EMIs: https://www.fca.org.uk/firms/apply/small-payment-institution-spi-small-emi

14.53 Given the reimbursement requirement that Section 62 of the Financial Services and Markets Bill places on the Payment Systems Regulator with respect to Faster Payments, the main direct impact and cost to a small PSP will be the financial cost of reimbursement by a small PSP for APP scam victims – the same burden which will fall on PSPs across the board. To some extent, the cost of this measure to individual PSPs scales directly with the number of transactions they process that are a result of an APP scam. Broadly speaking, this means that the cost will naturally scale with the size of the business.

14.54 Nevertheless, using averages calculated from system-wide data published by UK Finance[322], HM Treasury has developed crude estimates of the impact of these measures on small PSPs specifically, recognising that the ultimate impact will be dependent on:

a. the final form of PSR action;

b. the varying value and volume of payments that a PSP makes and receives, and the varying fraud rate through a small PSP, with the potential for significant variation in impacts for different individual PSPs (for example, if a PSP facilitates fraudulent payments above or below the average rate and values described below).

*Estimate: Inputs*

a. APP scam fraud rate: According to 2021 UK Finance industry data, 0.0098 percent of payments (or 1 in every 10,188 payments) resulted in an APP scam.[323]

b. Mean average value of an APP scam: The average value of each APP scam case was £2,677.[324]

c. Cost to a small PSP of an APP scam: No small payment institutions are signatories to the voluntary reimbursement Code, and many do not offer any other voluntary protections at present – hence, an average additional reimbursement burden per APP scam case of 100% (£2,677) is assumed. If a 50/50 split in reimbursement liability between the sending and receiving PSP were to be assumed (noting the liability split is for the PSR to decide as a result of PSR action), the cost to a small firm to reimburse the average APP scam would be £1,339.

d. Maximum monthly volume of Faster Payments processed by a small PSP: The monthly average value of the total payments a small PSP facilitates must be lower than 3 million euros (~£2,531,000) over the 12-month period preceding application for registration. Assuming all of the firms payments were the

322 https://www.ukfinance.org.uk/system/files/2022-06/Annual%20Fraud%20Report%202022_FINAL_.pdf

323 UK Finance/Pay.UK data

324 UK Finance data

average 2021 Faster Payment transaction value of ~£765[325], the maximum number of transactions a small payment institution or small electronic money institution could make would be 3308 per month (2531000/765).

*Estimate: Monthly and annual cost to a small PSP of APP scam reimbursement:*

Formula: 14.A: Estimate of costs to a small PSP or APP scam reimbursement

*(Number of Faster Payments processed by a small PSP monthly) × (APP fraud rate) × (average cost of an APP scam to a small PSP)*

And substituting the values calculated above:

a. 3308 × 1/10,188 × £1339 = £435 monthly cost of APP fraud reimbursement per firm

b. Average monthly cost of APP fraud × 12 = £435 × 12 = £5220 average annual cost of APP scam reimbursement per affected firm

14.55 Of the 559 registered small payment institutions, 477 (85%) are permitted to carry out money remittance only. Money remittance firms in the UK are typically used for sending international payments to individuals located abroad, and therefore these payments would not typically occur over Faster Payments, as a domestic sterling payment system, and would therefore not be subject to PSR action. It is therefore assumed that for these money remittance firms, there will be negligible, if any, impacts. This leaves a residual 82 small payment institutions that may regularly use Faster Payments, totalling 116 firms when the 34 small electronic money institutions are added.

Formula 14.B

*(Number of impacted firms) × (average annual cost of APP scam reimbursement per firm)*

14.56 And substituting the values calculated above:

a. 116 × £5220 = £605,520 total annual cost of APP fraud across impacted firms.

14.57 However, HM Treasury judges this to be a high-end estimate for SMBs when defined in the strict sense by their number of employees, for the following reasons:

a. HM Treasury expects that small (and certainly micro-) businesses, when defined in terms of employee count rather than according to the legislation defining a smaller provider, are unlikely to facilitate as much as £2,531,000 of payments every month. Likewise, the definition of a small payment

325 https://newseventsinsights.wearepay.uk/data-and-insights/faster-payment-system-statistics/

institution and small electronic money institution is likely to comprise a number of firms well above the threshold to qualify as an SMB.

b. this calculation assumes all victims receive 100% reimbursement, when currently the nature of the reimbursement requirement that the PSR will make is unknown and to be decided as a consequence of the legislation (rather than determined in the legislation itself).

c. this calculation assumes the PSR makes no differentiation between smaller PSPs and larger PSPs when designing its regulatory action. The PSR will have statutory requirements regarding proportionality and the production of cost-benefit analyses.

14.58 Given that small PSPs are not members of the voluntary Code for reimbursement today and may at least potentially have made less investment to date in their fraud controls, it is possible that small PSPs may experience a higher-than-average rate of APP scams. If that is the case, there may be a greater impact on these firms relative to PSPs with lower fraud rates. However, HM Treasury considers that the policy intent justifies that risk, and that exemption would not be appropriate as it would disadvantage the customers of small PSPs when compared to customers of larger PSPs (further explained in paragraphs below).

14.59 The PSR may differentiate between different sizes of business or via the timetable they may introduce for complying with the requirement, but it is not possible to anticipate that at this stage. The PSR is bound by statutory requirements regarding proportionality and the production of cost-benefit analyses, which will be produced at the appropriate time when it determines the actual, substantive requirement on firms.

14.60 A further indirect impact for small PSPs may be that they choose to invest in greater fraud prevention measures in order to limit the likelihood of needing to reimburse a victim in the future. HM Treasury does not have the data to quantify this in advance, although notably such investment may also have the intended effect of bringing down the overall cost to small payment institutions and small electronic money institutions of reimbursement. As such, this cost is expected to have some degree of inverse proportionality to a firm's ongoing reimbursement cost.

14.61 Another indirect impact to small PSPs may be transitional and familiarisation costs, insofar as SMB PSPs are required to be involved in receiving and processing reimbursement claims from customers. With regards to the legislative measure itself, HM Treasury expects these costs to be relatively minor, for the following reasons:

a. The clauses are relatively short, implying lesser resources need to be spent on legal familiarisation by firms.

b. The introduction of the measure is being well publicised by the PSR, which is embarking on extensive engagement with stakeholders, ensuring strong industry preparedness.

14.62 With regards to the impacts of the PSR's regulatory action that will follow this measure, HM Treasury is unable to quantify any transitional or familiarisation costs given that the nature of this action and its complexity is not yet determined. However, HM Treasury expects this type of cost would be included within cost-benefit analysis undertaken by the PSR ahead of its regulatory action.

14.63 As for any PSP, the extent of these impacts will be dependent on the final form of regulatory action that the PSR introduces – as such, the impact of the measure can only be properly measured once the PSR consults on its proposed approach to reimbursement, at which time the usual statutory requirements for proportionality and the production of cost-benefit analysis will apply to the regulator.

Could small and microbusinesses be exempted while achieving the policy objectives?

14.64 While it will be for the PSR to determine its final approach, HM Treasury considers it is proportionate (in terms of meeting the policy objective of ensuring consistent protections for victims of APP scams) to enable the PSR to require reimbursement, regardless of the size of PSP which processes a payment transaction. The legislation therefore does not propose *ex ante* for such an exclusion to be made albeit that the final design and how liability is apportioned will be a matter for the PSR to consult on and produce cost/benefit analyses.

14.65 In the design of the legislation itself, SMBs could not be exempted without risking compromising the policy objective. This is for the following reasons:

14.66 A major issue with the existing reimbursement regime is inconsistency in reimbursement outcomes for customers of different PSPs. Exempting small PSPs would render some customers arbitrarily unprotected from receiving mandatory reimbursement, replicating the issues of the current regime. It would also have significant consumer protection risks as it is unlikely that consumers would understand the difference in protection based purely on the size of firm that they choose to be their provider.

14.67 In turn, exempting small PSPs could in fact disadvantage those smaller firms. If customers became aware that they were not entitled to mandatory reimbursement if they used a small or microbusiness as their PSP, they may avoid using their services and favour larger market players.

14.68 An important secondary objective of the measure is to encourage firms to improve their anti-fraud capabilities, incentivised via a reduced financial burden to reimburse victims. Exempting small PSPs would remove this incentive for those firms, which may in turn attract fraudsters to target customers at such firms and exacerbate the problems facing SMBs and their customers.

14.69 The PSR will consult with industry and undertake a cost-benefit analysis when designing its specific regulatory action.

Could the impact on small and microbusinesses be mitigated while achieving the policy objectives?

14.70 HM Treasury does not consider that mitigation of the impact of this measure on small PSPs would be appropriate for the reasons explained above. Moreover, the measure enables (and requires) the PSR to take action; the legislation does not itself specify the particular reimbursement requirement. It is the responsibility of the PSR to ensure their regulatory action is proportionate to different sizes of firms, and to consider what mitigations may be necessary in the design and/or implementation of the measure it takes.

Wider impacts on small and microbusinesses

14.71 Considering the wider impacts on SMBs more broadly across the economy (as opposed to for small payment institutions and small electronic money institutions specifically): HM Treasury expects an indirect positive financial impact as some micro-businesses which are customers of PSPs, will benefit from the reimbursement mandate themselves, as business accounts are also subject to APP scams.

14.72 Although this cannot be accurately quantified, in 2021 £77.4 million was lost to APP fraud on non-personal (e.g. business) accounts, of which only £24.4m was reimbursed.[326] Although not all of these cases will involve small or micro businesses, and although the PSR's regulatory action is to be decided with regards to mandatory reimbursement on businesses accounts, there is potentially several million pounds of reimbursement from which SMBs could benefit.

14.73 As noted by the PSR Panel in its Report on the Digital Payments Initiative[327], one factor limiting the use of digital payments was "A distrust of digital payments as a result of concerns about fraud, personal error or privacy". As such, PSPs, including those that are SMBs, may benefit from increased consumer confidence as a result of the clearer entitlement to compensation in the event of being a victim of an APP scam. This could lead to increased use of PSPs.

326 https://www.ukfinance.org.uk/system/files/2022-06/Annual%20Fraud%20Report%202022_FINAL_.pdf

327 https://www.psr.org.uk/media/x3tjjuj1/psr-panel-dpi-report-may22.pdf

## Regulatory Gateway for Approving Financial Promotions

**Problem under consideration**

15.1 A financial promotion is a communication that contains an invitation or inducement to engage in a financial product or service. Such communications can take a wide variety of forms, including advertisements placed through print, broadcast, or online media; marketing brochures; direct mail; or use of social media.

15.2 Financial promotions are often consumers' first contact with a financial opportunity (such as a possible investment opportunity) and so can have a significant influence over the financial decisions they make. The communication of financial promotions is subject to regulatory safeguards which seek to ensure that consumers are appropriately protected such that they are able to make informed and appropriate decisions.

15.3 It is not necessary to be authorised by the PRA or the FCA to communicate a financial promotion. However, financial promotions communicated by firms that aren't authorised must be approved by firms that are authorised by the FCA or PRA, unless an exemption applies.[328] This means that currently any of the 51,000 firms authorised by the FCA can approve a financial promotion of any unauthorised firm. Moreover, the FCA has identified cases where firms were approving promotions without the relevant expertise, or without undertaking due diligence as per FCA rules and guidance.

15.4 There is currently no specific assessment of an authorised firm's suitability to approve financial promotions. This gives rise to three risks:

a. A firm can approve the financial promotion of another firm in an area in which it has no specific expertise.

b. Some firms may approve the financial promotions of unauthorised firms without undertaking sufficient due diligence around the firm or the promotion.

c. It acts as an obstacle to the FCA in exercising appropriate regulatory oversight of those firms that are approving the financial promotions of unauthorised persons. For example, firms are not currently required to notify the FCA when they are approving the financial promotions of unauthorised firms. The FCA therefore often only finds out about financial promotions that

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[328] Section 21 of the Financial Services and Markets Act 2000 (FSMA) contains the financial promotion restriction. This restriction is broad in scope and provides that a person must not, in the course of business, communicate an invitation or inducement to engage in investment activity or claims management activity. The financial promotion restriction does not apply if the: communication is made by an authorised person; content of the communication is approved by an authorised person; or the financial promotion otherwise meets the conditions of an exemption within the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (FPO). The effect of the financial promotion restriction is that an unauthorised person must have its financial promotions approved by an authorised person before they are communicated (unless an exemption applies). Communicating a financial promotion in breach of breach of section 21 is a criminal offence on the part of the unauthorised person under section 25 of FSMA.

do not meet its rules via reports from consumers. This means that the FCA often only becomes aware of the potential for harm after it has occurred.

**Rationale for intervention**

15.5 Ultimately, these issues can result in the financial promotions of unauthorised firms (that are being approved by authorised firms) not meeting the FCA's standards, and consumers having insufficient information to understand this. Where financial promotions do not meet the FCA's standards this can result in a significant harm to consumers, including financial loss, re-direction of investment away from more appropriate products, and a loss of consumer confidence in the financial services sector. Given the potential for consumer harm and market failure that can result from poor quality financial promotions, the government deems it necessary to update the financial promotion regime to address the risks that have been identified.

**Policy Objective**

15.6 The government's policy objective is to improve the quality of financial promotions communicated by unauthorised firms by ensuring that only authorised firms with sufficient expertise can approve the promotions of unauthorised firms. The government also aims to improve the FCA's oversight by giving it more supervisory powers over the approval of financial promotions and reducing the number of authorised firms that are able to undertake such approvals. It is hoped that this will reduce the consumer harm that has been seen previously because of poor quality financial promotions, described in the section above.

**Description of Options considered**

15.7 Two options were considered to deliver these objectives, alongside the option to remain with the current regulatory framework. These options were considered as part of the '*Regulatory Framework for the Approval of Financial Promotions*' consultation[329] that ran from 20 July to 26 October 2020.

15.8 Option 0 (Do nothing) - This would mean that any authorised firm would still be able to approve the financial promotions of unauthorised firms without the necessary competence and expertise. As set out, this can result in financial promotions not meeting the FCA's standards, which can negatively affect consumers.

15.9 Option 1 (Preferred Option) - creating a financial promotion 'gateway'. This would mean that authorised firms would only be able to approve financial promotions of unauthorised firms if they are granted express permission by the FCA. The FCA would set the appropriate rules and requirements for authorised firms who wish to approve the financial promotions of unauthorised firms. This would require an amendment to section 21 of FSMA to remove the general ability of unauthorised persons to communicate financial promotions which have been approved by any authorised firm. Instead, a requirement would be created so that unauthorised persons would only be able to communicate their own financial promotions if these

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329 https://www.gov.uk/government/consultations/regulatory-framework-for-approval-of-financial-promotions

had been approved by a firm which had been granted that express permission by the FCA (i.e. had passed the new 'gateway').

15.10 Option 2 (Non-preferred) - making the approval of financial promotions a regulated activity. This would involve amending the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (RAO) to make the approval of financial promotions of unauthorised persons a regulated activity, with firms requiring a Part 4A permission from the FCA before they could undertake the activity. Section 21 of FSMA would also have to be amended to require that only financial promotions of unauthorised persons approved by a firm with the relevant Part 4A permission could be lawfully communicated.

15.11 Making the approval of financial promotions a regulated activity (Option 2) could achieve a similar result to the preferred option. However, the benefits of the preferred option are that it would achieve the result of strengthening the FCA's ability to ensure that authorised firms comply with FCA rules when approving the financial promotions of unauthorised persons, without fundamentally altering the overall regulatory architecture of the financial promotion regime. Option 2 would represent a significant departure from the current regime by making the approval of financial promotions a regulated activity, which could have unintended consequences for the regulation of financial promotions in general. If this option was taken forward, it would mean that firms carry on a regulated activity when approving the financial promotions of others but not when communicating their own promotions. This would be a significant divergence of regulatory treatment between firms communicating their own promotions and approving promotions of other firms.

**Outline of preferred policy**

15.12 The preferred policy option is to introduce a 'financial promotions gateway' by creating a financial promotion requirement in FSMA (Option 1). This would require firms to obtain the specific consent of the FCA before they can approve the financial promotions of an unauthorised firm. The FCA would only grant permission to approve financial promotions to those firms with relevant expertise, and the FCA would be better able to supervise approving firms as they would be smaller in number. The FCA would consult on draft guidance for gateway approvers following the publication of legislation.

**Methodology**

15.13 This Bill will set out the framework for the financial promotions gateway. The costs of the regime as they apply to firms will largely be determined by the FCA and the rules it puts in place after the legislation is in force, setting out the requirements that firms need to meet in order to pass through the gateway. This impact assessment provides initial estimates of the costs associated with the regulatory gateway. The FCA will conduct a detailed cost benefit analysis on the final rules and guidance that will apply once the necessary legislative changes have been made. The assumptions are explained in more detail in the 'Policy Costs' section below.

15.14 An upper and lower bound has been presented for the costs. The lower bound has been calculated on the assumption that the number of firms approving financial promotions will remain at around 32 (the number of approving firms of which the FCA is aware, although there could be others) and the higher bound has been calculated on the assumption the number of these firms will rise to 100. As of January 2022, the FCA understands that of the 32 firms that approve financial promotions, 31 are small firms and one firm is medium-sized. The FCA further assumes that any additional firms approving financial promotions, following the implementation of the gateway (which would bring the estimated total number of gateway approvers to 100) would all be small firms.

15.15 IT costs and staff training costs are not expected to arise as a result of this measure. As explained in the 'Policy Costs' section below, it is expected that gateway approvers will not need to update their IT systems to comply with this measure. The costs to firms of understanding this measure and taking the necessary steps to implement it are captured within "familiarisation and legal costs" and the ongoing costs described below; it is assumed that one of the members of staff who familiarises themselves with the detailed requirements of the proposed rules and guidance will also be responsible for complying with any reporting requirements (described in the ongoing costs section below).

15.16 Further details will be set out in the secondary legislation that is enabled by the Bill. HM Treasury will provide a further impact assessment in each instance where it makes such secondary legislation. However, to inform an assessment of the bill the government has set out the possible costs and benefits. It is important to note however that the below costs and benefits are illustrative and any costs and benefits to firms will be contingent on the exact nature of the secondary legislation and on the steps the FCA takes in relation to implementing the gateway, which remain subject to consultation.

15.17 At the point of secondary legislation, and in line with the government's approach to better regulation under the Better Regulation Framework, HM Treasury will make efforts to further consult on and understand the potential further impacts of this measure, including through appropriate stakeholder engagement. More detailed qualitative and quantitative cost-benefit analyses are expected to be covered in the IAs accompanying the relevant secondary legislation enabled by the Bill. HM Treasury will also engage with the RPC, prior to the submission of IAs produced to accompany future secondary legislation where appropriate.

15.18 This impact assessment does not consider costs and benefits that arise from the FCA's wider work to strengthen their own rules for firms approving financial promotions. Those measures are being taken forward by the FCA under their existing rulemaking powers.

Population within scope of this proposal

15.19 The firms affected by these changes will be those that apply to the gateway and also unauthorised firms which have to have their financial promotions approved by authorised firms. As of January 2022, the FCA were aware of approximately 32 firms in the UK that were actively approving financial promotions, but it has indicated that in the coming years this number could increase to closer to 100.[330] The future number of approvers will depend on the number of firms who decide to apply to become gateway approvers, and will be subject to future decisions by the FCA on those firms' gateway applications.

**Policy Costs**

Transitional Costs

15.20 A summary of the estimated one-off costs for gateway approvers is set out in Table 16.A. Details on how these costs have been estimated are explained below.

Table 16.A: Estimated one-off costs to gateway approvers

| Cost Category | Lower Bound (32 firms) | Upper Bound (100 firms) |
|---|---|---|
| Familiarisation and legal costs | £20,000 (£625 per firm) | £60,800 (£608 per firm)331 |
| Gateway application fee | £160,000 (£5,000 per firm) | £500,000 (£5,000 per firm) |
| Other costs related to the application | £48,000 (£1,500 per firm) | £195,000 (£1,950 per firm) |
| Total one-off costs for gateway approvers | £228,000 (£7,125 per firm) | £755,800 (£7,558 per firm) |

*Familiarisation and legal costs*

15.21 It is assumed that affected firms will familiarise themselves with the detailed requirements of the proposed rules and guidance. The FCA has provided an early indication that there could be approximately 60 pages of policy documentation, excluding the FCA's legal instrument, outlining the relevant rules and guidance. Firms looking to become gateway approvers will need to familiarise themselves with the relevant guidance once it is published, which will detail the FCA's expectations for gateway approvers. Assuming 300 words per page and a reading speed of 100 words per minute, it would take around 3 hours to read the document. Based on the experience of bringing funeral plans into regulation, where familiarisation with new policy was also required, it is further assumed that 5 staff at each medium firm and 2 staff at each small firm will read the text.

330 There are two major reasons why the FCA expects the number of gateway approvers to increase, 1) the government is making changes to tighten up the financial promotion exemptions, the consultation for which can be found here and 2) cryptoassets are being brought within the scope of the financial promotions regime. Both of these amendments mean that more unauthorised firms (cryptoassets activity is generally unregulated) will require their financial promotions to be approved before they can be communicated, which the FCA expects will lead to more authorised firms wishing to offer this service.

331 The cost per firm is higher in the lower bound estimate than the upper bound. This is because the lower bound estimate includes medium-sized firms which incur higher costs, whereas the upper bound estimate assumes new gateway approvers will be small firms. This is explained in detail in paragraph 15.

15.22 With regard to legal costs, the FCA has provided an early estimate that the legal instrument setting out the rules to be 60 pages of legal text. Based on the experience of bringing funeral plans into regulation, it is anticipated that 2 staff at each medium sized firm and 1 legal staff at each small firm will read the text, and that it will take 2.5 hours per member of staff to review 50 pages of legal text. It is therefore assumed that it will take 6 hours per medium sized firm and 3 hours per small firm to review the legal text. It is expected that all firms in scope will incur familiarisation costs.

15.23 Formula 16.A is used to calculate familiarisation and legal costs.

Formula 16.A

*Additional minutes of staff time x average cost of time per minute x number of firms*

15.24 This results in a total familiarisation and legal cost for gateway approvers to be £20,000 for the lower bound number of firms (32), and £60,800 for the upper bound number of firms (100). On average this would cost £625 per gateway approver for the lower bound estimate, and £608 per gateway approver for the upper bound estimate. This may vary slightly depending on the size of the firm that chooses to carry out gateway approvals in the future. These estimates are subject to change, depending on the final FCA policy and legal documentation.

*Gateway application fee*

15.25 Resourcing and operating the gateway is expected to lead to the FCA incurring additional costs. The FCA has yet to consult on whether, and if so at what level, to levy an application fee for firms applying to the gateway.

15.26 In order to estimate what firms could be charged, it is assumed that any fee charged will be comparable to those in existing FCA authorisation regimes. Based on the experience of funeral plans regulation, where the FCA charge funeral plan providers £5,000 each in authorisation fees to go through their authorisation processes to 'carry out' funeral plans, it is estimated that the FCA will charge an application fee of £5,000. However, any such fee remains subject to consultation.

*Other costs related to the application*

15.27 Firms seeking to become gateway approvers will need to complete an application form. Based on the experiences of bringing claims management companies and funeral plans into regulation, it is estimated that it would take 3 to 4 working days of a compliance officer's time per firm to complete the gateway application. Assuming that the hourly rate of a compliance officer is £65 per hour (as was assumed in HMT's 2019 impact assessment on funeral plans) and assuming a 7.5 hour working day, this would mean an estimated cost of £1,500 to £1,950 per firm. This results in estimated total costs of £48,000 at the lower bound, and £195,000 at the upper bound.

15.28 The FCA has indicated that it does not expect gateway approvers will need to update their IT systems to comply with any reporting requirements. This is because any

reporting requirements which are imposed are expected to use an existing data collection platform for firms.

Ongoing costs

*Reporting requirements for gateway approvers*

15.29 The FCA is expected to consult on rules applying to firms which pass through the gateway. The FCA has indicated that it is likely to consult on applying reporting requirements for such firms in line with the stated rationale of this policy to enable the FCA to exercise appropriate regulatory oversight of firms which are approving financial promotions. The details of the FCA's proposals have yet to be published and remain subject to consultation.

15.30 While the FCA have not yet consulted on any reporting requirements, these requirements could entail (i) notifying the FCA of a financial promotion approval, and (ii) reporting on financial promotions approval activity.

15.31 The FCA's reporting requirements are subject to consultation and so are subject to change. However, it is estimated that to notify the FCA of a financial promotion approval, it would require one hour of a compliance officer's time per approval. This is estimated at a cost of £65 per approval.

15.32 On the requirement to report financial promotions approval activity, it is estimated that this would require six hours of a compliance officer's time per year, with sign-off by a firm's senior staff member requiring two hours per year. The total ongoing cost is estimated to be £16,600 per annum at the lower bound, and £52,000 per annum at the upper bound. On average this would cost £520 per gateway approver.

*Charges for firms applying to have their financial promotions approved*

15.33 There may be an increase in the charges for firms looking to have their financial promotions approved by authorised firms. This is both because firms are likely to pass on the costs outlined above and because the number of firms that are able to approve financial promotions will be restricted from a firm population of 51,000 to an estimated 100, making it a scarcer service.

Policy Benefits

*Consumer protection for those investing in products issued by unauthorised firms*

15.34 As previously noted, the FCA has identified instances where the financial promotions of unauthorised firms approved by authorised firms have not met the FCA's standards. This can result in significant harm to consumers, including financial loss, re-direction of investment away from appropriate products, and a loss of consumer confidence in the financial services sector.

15.35 A key benefit of the gateway will therefore be for consumers who wish to invest in products issued by unauthorised firms. The gateway will help to ensure that the financial promotions that these investors receive are of sufficient quality, therefore enabling investors to be able make informed decisions when choosing to invest.

*Gateway approvers - revenue*

15.36 Gateway approvers will benefit from this measure by being able to approve the financial promotions of unauthorised firms, relative to authorised firms without approver-permissions that will not be able to approve financial promotions. Gateway approvers will be able to charge a fee from unauthorised firms who wish to have their financial promotions approved. The quantitative benefits of this will depend on the number of financial promotions approved, which will vary across firms. However, as it is a choice for a firm to become a gateway approver, it can be assumed that the benefits to gateway approvers relative to authorised firms without approver permissions will outweigh the costs set out above.

**Assumptions, limitations, and considerations**

15.37 N/A

**Small and MicroBusiness Assessment (SaMBA)**

Number and distribution of businesses in scope of the regulation

15.38 This measure establishes a regulatory 'gateway', which authorised firms must pass through before being able to approve the financial promotions of unauthorised firms. As this measure sets the framework for the gateway, there are no quantifiable impacts at the stage of primary legislation.

15.39 The FCA is unable to estimate how many unauthorised small and microbusinesses (SMBs) are having their financial promotions approved by authorised firms, as there is no requirement on firms to report this information.

15.40 The total number of SMBs who are directly captured by the measure's requirements will be relatively small. As outlined above, the total number of approvers is currently estimated to be 32 as of January 2022, and while it could rise significantly to 100 in the coming years, the FCA does not expect significant growth beyond that. The FCA do not hold data on firm size by number of employees. However, of the estimated existing 32 approvers, the FCA consider one as a "medium" firm and the other 31 firms as "small" firms based on their relative rankings in terms of underlying metrics such as annual income and gross premium income. This figure of 31 firms will be used as a proxy to estimate the number of SMBs currently potentially in scope of this measure.

Do the impacts fall disproportionately on small and microbusinesses?

15.41 As set out above, currently there are estimated to be 31 "small" firms who approve financial promotions which could be affected by the FCA's rules resulting from this measure.

15.42 Once the FCA have confirmed the gateway rules and the regulatory gateway is open, approver firms will have one-off transitional costs and ongoing costs. As set out previously, the one-off cost for the lower bound (32 firms) is estimated to be £7,125 per firm, while the one-off cost for the upper bound (100 firms) is £7,558 per firm. These direct costs on authorised firms going through the gateway are expected to be passed on to unauthorised firms that are seeking approval of their financial promotions.

15.43 From their supervisory work, the FCA estimate firms charge between £5,000 and £15,000 for approving a financial promotion, depending on the nature and complexity of the product. The FCA is unable to provide figures to illustrate to what extent these costs will increase as approver firms pass on the additional cost to approve financial promotions following the implementation of the gateway.

Could small and microbusinesses be exempted while achieving the policy objectives?

15.44 Any rules that the FCA introduces as a result of the measure are expected to apply to SMBs, and the policy objectives could not be achieved if SMBs were exempted. Exempting SMBs would undermine the intention of the legislation by allowing SMBs to approve financial promotions without sufficient expertise, putting investors at risk of receiving financial promotions which are not of a sufficient standard. Poor quality financial promotions can result in significant harm to consumers, including investor loss, re-direction of investment away from more appropriate products, and a loss of consumer confidence in the financial services sector.

15.45 It is therefore important to ensure that the measure applies to all businesses that approve financial promotions. The measure will help address issues of consumer harm and serve to improve the quality of financial promotions that are approved for unauthorised firms. These benefits to individual consumers outweigh the cost that the measure will have on SMBs.

Could the impact on small and microbusinesses be mitigated while achieving the policy objectives?

15.46 Once the FCA have confirmed the regulatory gateway rules and the gateway then opens, smaller firms will be able to mitigate the costs of complying with the measure through the financial promotion approval fees they charge to unauthorised firms who wish to have their financial promotions approved. In order to help firms, including SMBs, prepare their application to the new regulatory gateway, there will be an appropriate window for firms to apply as well as a transitional period. Ahead of this, the FCA is expected to publish its final rules and guidance (following consultation), so firms have advanced sight of them and time to prepare.

15.47 SMBs seeking to have financial promotions approved may be affected by an increase in the amount charged by approvers following the implementation of the gateway, as some approvers of financial promotions will likely choose to pass on the additional costs associated with the gateway. The FCA will closely monitor the marketplace for approving financial promotions and consider acting where necessary. In particular, the FCA are considering changes in the future which may see them collecting data from firms on revenue earned from financial promotion approval activity in order to help them identify any impacts on competition. The FCA have also extended existing 'conflicts of interest' obligations to firms approving financial promotions for unauthorised persons in their August 2022 Policy

Statement[332], in order to prevent firms from using their position as a gateway approver to gain a competitive advantage over rival firms.

Wider impacts on small and microbusinesses

15.48 Wider impacts on SMBs are not easily identified and are therefore more difficult to assess. The regulatory gateway aims to improve the quality of financial promotions communicated by unauthorised firms, and reduce the risks of harm to consumers that can arise from inappropriate promotions. It is anticipated that this measure could increase individuals' confidence in the financial promotions of financial services firms and therefore could have a positive impact on the UK economy. This potential benefit has not been quantified.

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[332] https://www.fca.org.uk/publication/policy/ps22-10.pdf

# Additional Technical Amendments

## Powers in Relation to Critical Third Parties

**Problem under consideration**

16.1 The policy objective is to verifiably raise the resilience of the material services critical third-parties provide to the finance sector, and thus mitigate risks to financial stability and the Bank of England (Bank), PRA's and FCA's ('the regulators') objectives.

16.2 Firms and financial market infrastructure ('firms') supervised by the regulators are increasingly outsourcing important services to third-party service providers ('third-parties') outside the supervisory and regulatory perimeter. For example, firms are increasingly using third parties for cloud services, and according to one estimate, between 40%-90% of banks' workloads globally could be hosted on the cloud within a decade.[333]

16.3 Outsourcing can come with many benefits. For example, outsourcing can turn fixed costs in infrastructure into variable costs, which can drive down entry barriers and support innovation and rapid scaling.[334] Outsourcing can also strengthen the resilience of individual firms, as specialised third parties may be better equipped to maintain secure systems than firms, and the use of geographically dispersed sites by these entities can support business continuity.[335]

16.4 While these efficiency and resilience improvements mean outsourcing is beneficial for firms, use of third parties can also create risks.[336] In particular, where many firms are using the same third-party (e.g. a large cloud service provider) to support important business services, failure or disruption at this 'critical' third-party could have systemic impacts if services are not appropriately resilient. Specifically, disruption could pose a threat to financial stability and the regulators' objectives.

16.5 Recent data shows that a small number of critical third parties to the finance sector are emerging. For example, as of 2020, over 65% of UK firms use the same four providers for cloud infrastructure services.[337] Furthermore, as explained below, critical third-party services may not be appropriately resilient.

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333 Information sourced from: https://www.bankofengland.co.uk/-/media/boe/files/report/2019/future-of-finance-report.pdf?la=en&hash=59CEFAEF01C71AA551E7182262E933A699E952FC.

334 Effect documented in: https://voxeu.org/article/economics-cloud-computing.

335 Effect documented in: https://publications.parliament.uk/pa/cm201919/cmselect/cmtreasy/224/224.pdf.

336 Risks documented in: https://voxeu.org/article/systemic-consequences-outsourcing-cloud-0.

337 Information sourced from: https://www.bankofengland.co.uk/bank-overground/2020/how-reliant-are-banks-and-insurers-on-cloud-outsourcing.

Legislative context

16.6 The regulators already have some powers to support this policy objective, but they are limited in crucial respects. For instance, through their rule-making powers, the regulators can impose requirements on firms, which must be reflected in their contractual agreements with third parties. In 2021, for example, the PRA introduced Supervisory Statement (SS) 2/21, which contains modernised expectations on outsourcing and third-party risk management for dual-regulated firms. Under this policy, firms' contracts with third parties are expected to cover aspects such as data security and business continuity.[338] This followed the FCA's similar Finalised Guidance (16/5), introduced in 2016 and updated in 2019.

16.7 However, these expectations only bind third parties indirectly via their contractual arrangements with firms. Moreover, due to the relative size of critical third-parties, firms frequently report being unable to ensure that their contractual arrangements with them adequately allow them to satisfy their regulatory obligations.[339]

16.8 This issue could be managed more effectively if the regulators had direct powers over the material services critical third parties provide to the finance sector. For example, as explained below, if HM Treasury could designate critical third parties, and the regulators had rule-making, information-gathering and enforcement powers over the services these entities provide, this could verifiably raise the resilience of services provided to firms. Alternatively, if HM Treasury could extend the regulatory and supervisory perimeter to critical third parties, thereby giving the regulators an even wider range of powers (e.g. to review management appointments), a similar outcome could be achieved.

16.9 The regulators do have some direct powers over critical third parties. For example, they have limited, direct information gathering powers over third parties. Specifically, the PRA has the power to gather information from service providers to FCA and PRA-regulated firms, where this is considered relevant to the UK's financial stability, or reasonably required by the Bank in connection with the exercise of its functions in pursuance of its financial stability objective.

16.10 However, this power is only exercisable by the PRA, not by the FCA or the Bank and can only be exercised if there is a serious threat to financial stability. Moreover, information gathering alone is unlikely to result in defined improvements in the resilience of critical third-party services, as it does not enable the regulators to set minimum resilience standards for the services critical third parties provide to firms, fully assess their resilience, or penalise these entities in cases of non-compliance.

16.11 HM Treasury and the regulators also have some powers to extend the regulatory and supervisory perimeter to third parties of a specific subset of firms. In particular, HM Treasury has the power to 'specify' (i.e. designate) service providers to recognised payment systems, thereby bringing them inside the Bank's regulatory and

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338 For more information on SS 2/21, see: https://www.bankofengland.co.uk/prudential-regulation/publication/2021/march/outsourcing-and-third-party-risk-management-ss.

339 Feedback from confidential consultation with relevant industry stakeholders, including representatives from over 40 firms.

supervisory perimeter. Once a service provider has been specified, the Bank has the power to gather information, publish principles to which these entities must have regard, and take enforcement action.

16.12 HM Treasury's and the Bank's powers over specified service providers to recognised payment systems are also, however, limited. These powers only apply in respect of third parties to recognised payment systems, and not in respect of third parties to other firms. Moreover, even if these powers could be extended to third parties to other firms, bringing certain critical third parties into the full regulatory and supervisory perimeter of a financial regulator could be controversial and disproportionate. This is because these entities provide services to many different sectors besides the finance sector, so it is not clear why the financial regulators should be able to supervise them like finance firms.

**Rationale for intervention**

16.13 As noted, failure or disruption at a critical third-party could have systemic impacts across the finance sector. For these impacts to be deemed likely, however, there must be reason to suspect critical third-party services are not appropriately resilient. In this context, 'resilience' means the ability to prevent, respond to, recover and learn from operational disruptions, including by restoring those services that are most important to the regulators' objectives, including financial stability.

16.14 The existence of market failures in the provision of services by critical third parties to firms means there are good reasons to suspect these entities cannot respond in this way. For example, there are likely to be information and power asymmetries between critical third parties and firms. Owing to the relatively larger size and greater bargaining power of critical third-parties, firms report being unable to obtain adequate assurances about the resilience of the services that these entities provide after entering contractual agreements.[340] This, in turn, suggests resilience standards at critical third parties are likely to be lower than firms would prefer if information asymmetries didn't exist.

16.15 There are also likely to be externalities in the provision of services by critical third parties. For instance, as noted, disruption at a critical third-party could have systemic impacts across the finance sector. This risk cannot be managed by individual firms alone, since contractual decision-making by other firms is out of their control. This means the effect of disruption on a particular firm is likely to be greater than that firm anticipates when negotiating a contractual agreement with a critical third-party. Even aside from information asymmetries, therefore, firms are likely to impose insufficiently stringent standards on the services critical third parties provide.

Previous interventions

16.16 The regulators have already been granted a number of powers, which can be used to promote the resilience of critical third-party services. For example, as set out above, through their rulemaking powers, the FCA and PRA require firms to maintain

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[340] Information sourced from the regulators' internal records.

contractual agreements with third parties, which meet certain obligations on security and resilience.

16.17 The regulators also allow critical third parties to voluntarily take part in the threat intelligence-led penetration testing of selected firms (through the CBEST programme) but cannot carry out these tests directly on critical third-parties.[341] In principle, this could raise the resilience of critical third-party services, by testing the way these entities respond to a cyber-attack on the systems they provide to firms.

16.18 However, as noted above, owing to the relative size and bargaining power of critical third-parties, firms report being unable to verify third-parties' compliance with contractual terms. Supervisors also report little or no voluntary participation of critical third parties in threat intelligence-led penetration testing. Previous interventions, therefore, cannot be used to effectively monitor or strengthen the resilience of critical third-party services.

Previous commitments

16.19 Finally, granting the regulators more powers over critical third-party services in primary legislation would implement the recommendations of recent reports, including some commissioned by the government. These reports include: (i) the 2019 Treasury Select Committee report on 'Information Technology (IT) failures in the Financial Services Sector'[342]; (ii) the 2021 'Kalifa Review of UK FinTech'[343]; and (iii) the 2022 International Monetary Fund's UK Financial Sector Assessment Programme (draft) report.[344] All three of these reports note the financial stability risks posed by critical third parties, and recommend further work in this area, consistent with the government's proposed measures.

**Policy Objective**

16.20 The objective of this policy is to verifiably raise the resilience of the material services that critical third parties provide to the finance sector, and therefore mitigate risks to financial stability and the regulators' objectives.

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341 CBEST is the regulators' threat intelligence-led penetration testing framework, wherein ethical hackers are hired to test a firm's cyber defences. For more information, see: https://www.bankofengland.co.uk/-/media/boe/files/financial-stability/financial-sector-continuity/cbest-implementation-guide.pdf.

342 For more information on the Treasury Select Committee report, see: https://publications.parliament.uk/pa/cm201919/cmselect/cmtreasy/224/224.pdf.

343 For more information on the Kalifa Review, see: https://www.gov.uk/government/publications/the-kalifa-review-of-uk-fintech.

344 For more information on the International Monetary Fund's assessment, see: https://www.imf.org/en/Publications/CR/Issues/2022/04/07/United-Kingdom-Financial-Sector-Assessment-Program-Some-Forward-Looking-Cross-Sectoral-516282.

## Description of Options Considered

16.21 Option 0 (Do nothing) - If nothing were done, the regulators would continue to use the tools they already have at their disposal to promote critical third-parties' resilience. However, these tools are not sufficiently strong to support the policy objective, as discussed above. There is no reason to suspect these powers will become any more effective in the future, so the resilience of critical third-party services is unlikely to verifiably rise. A material risk would thus remain, if this option is pursued, of disruption at a critical third-party leading to financial instability or detriment to the regulators' objectives. Since outsourcing to third parties is expected to rise, this risk could even grow.

16.22 Option 1 (Preferred Option) - The preferred option is to grant HM Treasury designation powers and the regulators limited rule-making, information-gathering and enforcement powers in relation to the services that critical third-parties provide to regulated finance sector firms. As discussed above, this would require changes in primary legislation. This option is likely to support the policy objective. If this option were pursued, HM Treasury (consulting with the regulators) would be able to designate critical third-parties subject to the proposed framework. The regulators would then be able to define minimum resilience standards for the material services these entities provide, assess whether these are met through resilience testing, and take action if they are not. This option would also achieve this policy objective in a proportionate manner. Although the regulators would be granted more powers over critical third parties, they would still only be able to undertake a limited range of activities in respect of these entities, which would reflect and be limited by their statutory objectives.

16.23 Option 2 (Non-preferred) - Grant HM Treasury the power to extend the regulatory and supervisory perimeter to critical third parties. As discussed above, this would also require changes in primary legislation. This option is also likely to support the policy objective. In particular, if this option were pursued, the regulators would also be able to define resilience standards, assess whether these are met through resilience testing, and incentivise compliance through enforcement. This option would not, however, achieve this policy objective in a proportionate manner. In addition to being able to undertake the activities above, under this option, the regulators would also be able to undertake further activities in respect of critical third parties. For example, they would be able to review senior management appointments in critical third parties, just as they can with firms. It is not clear, however, that these additional powers are necessary to support the policy objective, since critical third parties may provide services to many sectors.

## Outline of the preferred policy

16.24 The preferred policy option is to grant HM Treasury designation powers, and grant the regulators rule-making, information gathering and enforcement powers, over

the services that critical third-parties provide to firms. These four types of powers are described in detail below.

16.25 These powers will be granted in respect of all three of the regulators. Critical third parties may provide services to firms regulated by each of the Bank, PRA and FCA, and therefore pose a systemic risk to each of their objectives.

16.26 Delivering these four types of powers will require changes in primary legislation. Delivering these powers will also require delivering a regulation in secondary legislation specifying which entities are designated as critical third parties. The Bill will put this in secondary rather than primary legislation because this list of qualifying critical third parties will change over time.

16.27 At the point of secondary legislation, and in line with the government's approach to better regulation under the Better Regulation Framework, HM Treasury will make efforts to further consult on and understand the potential further impacts of this measure, including through appropriate stakeholder engagement. More detailed qualitative and quantitative cost-benefit analyses are expected to be covered in the IAs accompanying the relevant secondary legislation enabled by the Bill. HM Treasury will also engage with the RPC, prior to the submission of IAs produced to accompany future secondary legislation where appropriate.

16.28 There will be no immediate change to government or regulator rules and advice as a result of these changes in primary legislation. The regulators would, however, need to introduce new guidance as a result of this policy, setting out how they will exercise the proposed powers. In anticipation of these powers, the regulators have published a Discussion Paper (PRA Discussion Paper 3/22)[345], inviting industry feedback on potential uses of new statutory powers. This Discussion Paper indicates how the regulators may use new powers to make recommendations to HM Treasury on designation, define minimum resilience standards, introduce mandatory resilience testing, and take limited enforcement actions where needed. Subject to the outcome of Parliamentary debates and responses to the Discussion Paper, the regulators will then need to publish separate Consultation Papers on the use of new powers before issuing their final rules.

Designation powers

16.29 The Bill will grant HM Treasury the power to, after consulting the regulators, designate third parties as 'critical', on the basis of specified criteria and subject to specified safeguards.

[345] https://www.bankofengland.co.uk/prudential-regulation/publication/2022/july/operational-resilience-critical-third-parties-uk-financial-sector

16.30 This would allow the regulators to differentiate between critical and non-critical third parties when exercising their new powers. In the absence of this power, rule-making, information-gathering and enforcement powers could be granted to the regulators and exercised over all third-parties. But this is unlikely to be justified for non-critical third parties, since these do not pose systemic risks to financial stability and the regulators' other objectives.

16.31 Under this proposal, HM Treasury would have to consult with the regulators before an entity is designated as a critical third-party. In practice, this could be done following a recommendation from the regulators. The regulators would not need an explicit power to do this, since they already have the power make recommendations to HM Treasury.

16.32 To designate an entity as a critical third-party, HM Treasury must be satisfied that this entity is a 'third-party. The definition used would align with existing definitions but be appropriately qualified. For example, under this proposal, a 'third-party' could provide a range of services, including but not limited to data, software and hardware. A 'third-party' could also be both a direct and indirect supplier to firms, and be located either inside or outside the UK.

16.33 HM Treasury must also be satisfied that three high-level criteria for designation have been met. Firstly, that a third-party provides material services to firms (e.g. services supporting firms' critical economic functions). Secondly, that many firms, or a few significant firms (e.g. systemically important firms), rely on a third-party. Thirdly, that disruption at a critical third-party would impact financial stability (e.g. indicated by recovery time following disruption, substitutability of services, and ability of firms to continue services without substituting). These criteria will support proportionality, by ensuring only relevant entities are designated as critical third parties. The regulators may also, before making a recommendation to HM Treasury, develop more detailed interpretations of these criteria, to support objectivity.

16.34 HM Treasury's powers of designation would be subject to certain safeguards, comprising duties and qualified powers for HM Treasury. In particular, there would be duties on HM Treasury to: (i) consult the regulators and other relevant authorities (e.g. the Information Commissioner's Office (ICO)) before designating a critical third-party; (ii) notify a critical third-party before designating it and give it a reasonable period to make representations; (iii) have regard to representations made as well as the views of the regulators and other authorities. HM Treasury would also have the power to withdraw a critical third-party's designation. These safeguards would ensure HM Treasury is held accountable when designating potential critical third parties.

16.35 In principle, both regulated and non-regulated entities could be designated as critical. However, the government expects almost all designated critical third parties to be non-regulated. If a regulated entity is designated as critical, the regulators will be obligated to use their existing powers to promote that entity's resilience, before resorting to the rule-making, information-gathering and compliance powers below.

Rule-making powers

16.36 The Bill will grant the regulators the power to issue common rules over critical third parties in connection with the supervision of regulated entities.

16.37 This would allow the regulators, as envisaged in the regulators' Discussion Paper, to define minimum resilience standards and introduce mandatory resilience testing (e.g. scenario testing, sector exercising and threat intelligence-led penetration testing) in relation to critical third-party services.[346] In the absence of this power, although the regulators could still be allowed to gather information on critical third-party services, they would not be able to evaluate any information gathered.

16.38 Any rules issued by the regulators in respect of critical third-parties would have to be coordinated. This will avoid different regulators introducing different rules for the same critical third-party, which could be unduly burdensome.

16.39 Any rules introduced by the regulators, moreover, must be relevant to the supervision of regulated entities. This will ensure any rules issued by the regulators are binding only in relation to the services that critical third-parties provide to firms, rather than being binding over these entities as a whole. This, in turn, will support proportionality, since third-parties may provide services to other sectors, which are not relevant to financial stability. This will also support enforcement, since third-parties may be domiciled outside the UK, but still provide services inside the UK, creating a legal basis for enforcement.

Information gathering powers

16.40 The regulators will have the power to require a critical third-party to provide, within a reasonable time period, information or documents relevant to the supervision of regulated entities, and to conduct investigations.

16.41 The regulators will also have the power to obtain a view from an independent party ('a skilled person') about the same aspects of a critical third-party's services the regulators can request information and documents on. For example, a critical third-party's response and recovery arrangements for disruption to services supplying the finance sector might be investigated.

16.42 Although this would require a distinct statutory power to be granted to the regulators, skilled persons' reviews could in practice be treated as another form of resilience testing by the regulators. Given the cost of hiring a skilled person, it is likely this tool would only be used infrequently by the regulators.

16.43 These powers will allow the regulators to verify in detail whether minimum resilience standards have been met in relation to critical third-party services. In the absence of these powers, although the regulators would still be able to obtain some information on critical third-party services through their existing powers, this information would be limited.

[346] For more information on the Financial Policy Committee's comments in relation to critical third-party rule-making, see: https://www.bankofengland.co.uk/financial-policy-summary-and-record/2021/october-2021.

16.44 As with the regulators' rule-making powers, the regulators would have to coordinate when using these powers. This will avoid inconsistent requests being made of critical third parties.

Enforcement powers

16.45 The Bill will grant the regulators the power to take specified enforcement actions against critical third parties. This would be subject to specified safeguards and only in connection with the supervision of regulated entities.

16.46 This will allow the regulators to ensure compliance, where a critical third-party fails or refuses to comply with resilience standards, perform resilience tests or remediate serious issues (e.g. identified through a skilled persons' review). In the absence of this power, the regulators could still be granted rulemaking and information gathering powers, but critical third parties would have a limited incentive to reach minimum resilience standards.

16.47 The regulators will have the power to take specified enforcement actions where rules are breached, or information requests are not complied with. These would be limited to: (i) issuing a public or private warning of any impending enforcement action; (ii) publishing a statement stating that the relevant critical third-party is in breach; (iii) directing critical third parties to remediate breaches; (iv) disqualifying firms from using a critical third-party for new or existing services or allowing them to do so subject to certain conditions or limitations. These actions have been selected because they are both likely to drive compliance, and unlikely to be subject to legal challenge in respect of entities domiciled outside the UK. Where legal challenge does occur, this will be handled by the Upper Tribunal.

16.48 When exercising the power of disqualification, the regulators would be subject to specified safeguards. Before disqualifying firms from using a critical third party, the regulators must have shown this action is appropriate in the circumstances and be satisfied the execution of this action will not itself cause financial instability. Since moving services from one third party to another can be a lengthy process, there is a risk the use of this power could disrupt services across the finance sector. These safeguards should prevent this from happening.

16.49 As with the regulators' rulemaking and information gathering powers, the regulators will have to coordinate when using this power. This will avoid inconsistent requests being made of critical third parties.

**Methodology**

16.50 The relevant counterfactual for assessing the costs and benefits associated with this proposal is the situation in which no additional powers are granted to the regulators over critical third parties, and the regulators continue to use the tools they already have at their disposal.

16.51 Further details will be set out in the secondary legislation and regulator rules that are enabled by the Bill. HM Treasury will provide a further impact assessment in each instance where it makes secondary legislation. However, to inform an assessment of the bill the government has set out the possible costs and benefits. It is important to

note however that the below costs and benefits are illustrative and any costs and benefits to firms will be contingent on the exact nature of the secondary legislation.

16.52 At the point of secondary legislation, and in line with the government's approach to better regulation under the Better Regulation Framework, HM Treasury will make efforts to further consult on and understand the potential further impacts of this measure, including through appropriate stakeholder engagement. More detailed qualitative and quantitative cost-benefit analyses are expected to be covered in the IAs accompanying the relevant secondary legislation enabled by the Bill. HM Treasury will also engage with the RPC, prior to the submission of IAs produced to accompany future secondary legislation where appropriate.

16.53 Since this proposal involves granting powers to HM Treasury and the regulators, most of the costs and benefits that will arise as a result are indirect and will be due to subsequent action taken by HM Treasury and the regulators. As the size of these costs and benefits will vary depending on the way HM Treasury and the regulators use any powers granted to them, there is a degree of uncertainty over these figures. However, the regulators (via their Discussion Paper) have set out how they propose to use these new powers, if granted.[347] Moreover, there are existing sources of data that can help estimate potential costs (e.g. based on the historical costs of CBEST tests or skilled persons' reviews of regulated firms).

Population within scope of this proposal

16.54 The businesses primarily impacted by these changes are those entities that are likely to be designated as critical third parties. The number of critical third parties will be determined by HM Treasury, on the basis of the criteria proposed above. However, initial estimates suggest around 15-20 entities will be designated[348]. To be conservative, the upper bound estimate of 20 is used in the following analysis.

16.55 For the purposes of this analysis, it has been assumed that 20 critical third parties will be designated in the first year of the appraisal period, and no further entities are designated in later years. In reality, additional entities may be designated in later years, and some designated entities may lose their designation status. To a first approximation, however, this assumption is considered reasonable.

[347] For more information on the Financial Policy Committee's comments in relation to critical third-party rulemaking, see: https://www.bankofengland.co.uk/financial-policy-summary-and-record/2021/october-2021.

[348] Information sourced from internal discussions between HMT and the regulators. Estimate based on resource constraints of the regulators.

16.56 Firms will benefit from a reduced risk of disruption. Assuming this applies to around 15 entities supervised by the Bank[349], 1500 entities supervised by the PRA[350] and 46,260 entities supervised by the FCA[351], there are around 48,000 such entities.

**Policy Costs**

Transitional costs to business

*Familiarisation costs to critical third parties*

16.57 As a result of the policy, risk, regulatory and compliance professionals in potential critical third parties are likely to spend some time familiarising themselves with new legislation, thereby incurring opportunity costs. However, this would not be required of them unless and until they were designated under the legislation. Assuming businesses are overly cautious and multiplying the estimate for the number of critical third parties by 1.5[352] to capture this assumption, around 30 organisations might be expected to consider themselves as a potential critical third-party. Assuming there are around 10 relevant risk, regulatory and compliance staff[353], in each of these organisations, and each of these spends 16 hours familiarising themselves[354] at an hourly wage of £16.60[355], this will yield associated costs of around £100,000 (to the nearest £100,000) in the first year of the appraisal period.

16.58 If the regulators introduced minimum resilience standards or mandatory resilience testing for critical third parties, there would also be costs to risk, regulatory and compliance professionals in these entities, as they familiarise themselves with these standards. If there are 10 relevant risk, regulatory and compliance professionals in 20 critical third parties, and each of these spends 40 hours familiarising themselves with each new set of rules at an hourly wage of £16.60[356], related costs in the first year of the appraisal period will be around £200,000 (to the nearest £100,000).[357]

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349 Information sourced from: https://www.bankofengland.co.uk/financial-stability/financial-market-infrastructure-supervision.

350 Information sourced from: https://www.bankofengland.co.uk/prudential-regulation/authorisations/which-firms-does-the-pra-regulate#:~:text=The%20Prudential%20Regulation%20Authority%20regulates,insurers%20and%20major%20investment%20firms.

351 Information sourced from: https://register.fca.org.uk/s/.

352 Information sourced from internal discussions between HMT and the regulators. Estimate reflects an informed guess.

353 Information sourced from internal discussions between HMT and the regulators. Estimate reflects an informed guess.

354 Information sourced from internal discussions between HMT and the regulators. Estimate reflects an informed guess.

355 Information sourced from: https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworkinghours/datasets/occupation2digitsocashetable2. Estimate assumes median hourly wage of business and public service associate professionals in 2020 is a reasonably proxy.

356 Information sourced from: https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworkinghours/datasets/occupation2digitsocashetable2. Estimate assumes median hourly wage of business and public service associate professionals in 2020 is a reasonably proxy.

357 Information sourced from internal discussions between HMT and the regulators. Estimate reflects an informed guess.

16.59 The regulators may also choose to commission a skilled persons' review of critical third parties. The risk, regulatory and compliance professionals in these entities would then need to familiarise themselves with the skilled persons' review process. Assuming there are 10 relevant risk, regulatory and compliance staff in 20 critical third parties, and each of these spends 40 hours familiarising themselves at an hourly wage of £16.60, related costs in the first year of the appraisal period will be around £100,000 (to the nearest £100,000).[358]

*Familiarisation costs for firms*

16.60 Risk, regulatory and compliance professionals in firms may also spend some time familiarising themselves with these proposals. However, this is not a requirement, and it is unlikely these persons will require in-depth familiarity, so associated costs are assumed to be nil.

Ongoing costs to business

*Cost of critical third parties raising their resilience*

16.61 If the regulators introduced minimum resilience standards for critical third-party services, this could also lead to ongoing direct costs, as designated critical third parties take steps to raise resilience. Depending on the stringency of rules, these could vary. A reasonable estimate per critical third-party, however, could be costs of around £390,000 per year[359]. With 20 critical third-parties, direct investment costs could then be around £7,800,000 in each year of the appraisal period.

16.62 If the regulators introduced mandatory resilience testing for critical third-party services, there could also be ongoing service costs, as designated critical third parties deploy staff and pay providers to deliver mandatory testing. Assuming this costs £175,000 per test[360], and each entity is tested once every 3 years (with a uniform distribution), with 20 critical third-parties, related costs in each year of the appraisal period could be around £1,200,000. At least some of this sum will amount to a redistribution from critical third-parties to testing providers, and therefore not be a true cost. To be conservative, however, and capture costs from the diversion of trade, the government has included this figure.

*Cost of skilled persons' review every decade*

16.63 If the regulators commissioned a skilled persons' review of a critical third-party services, there could be ongoing direct costs to critical third parties that have to fund these. Assuming this costs £865,000 per review[361], and each entity is tested once

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[358] Information sourced from internal discussions between HMT and the regulators.

[359] Information from regulators' internal records. Prices in 2020 terms.

[360] Information sourced from the regulators' internal records on CBEST testing. Prices in 2020 terms.

[361] Information sourced from the regulators' internal records on skilled persons' reviews. Prices in 2020 terms.

every 10 years (with a uniform distribution), with 20 critical third-parties, related costs in each year of the appraisal period will be around £1,700,000.

**Policy Benefits**

*Reduced likelihood of disruption to financial services industry caused by critical third-party failure*

16.64 Estimating the expected cost of critical third-party disruption in the finance sector is difficult. However, it is possible to use other examples of financial disruption to illustrate the risks. Three relevant incidents, here, are a technology failure incident at the Royal Bank of Scotland in 2012, a major cyber incident at Tesco Personal Finance PLC in 2016, and a major incident at TSB Banking Group PLC in 2018. Respectively, these incidents are estimated to have cost £138,600,000[362], £23,200,000[363] and £339,500,000[364]. All of these incidents involved comparatively severe disruption, the likes of which could conceivably result from disruption at a critical third-party. Taking the average of these incidents, the cost of critical third-party disruption could be around £166,900,000.

16.65 An alternative way of estimating the cost of disruption would be to look at the average hourly cost of an outage in the finance sector. One such estimate places the hourly cost at around £4,100,000.[365] Multiplying this figure by 48 (i.e. 2 days) to reflect a severe incident, of the kind critical third-party disruption could conceivably cause, results in a comparable estimate of around £293,600,000.

16.66 Both of these figures, however, are likely to underestimate the likely cost of critical third-party disruption. This is because these figures are for isolated incidents, whereas critical third-party disruption is likely to have widespread impacts. At worst, critical third-party disruption could, for example, lead to disruption comparable to that seen at TSB Banking Group PLC at multiple firms at the same time. As a conservative estimate, disruption at a critical third-party, therefore, could involve costs 3 times higher than those of previous instances of major finance sector disruption.[366] Using the averages for Royal Bank of Scotland, Tesco Personal Finances PLC and TSB Banking Group PLC, critical third-party disruption could then result in costs of around £500,800,000.

16.67 Even this figure is likely to be an underestimate of the true cost of critical third-party disruption. In the event of such widespread disruption in the finance sector, there would also likely be market dysfunction. For example, if critical third-party disruption

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362 Information sourced from: https://www.rbs.com/rbs/news/2014/11/rbs-reaches-it-incident-settlement.html. Prices in 2020 terms.

363 Information sourced from the regulators' internal records. Prices in 2020 terms.

364 Information sourced from: https://www.theguardian.com/business/2019/feb/01/tsb-computer-meltdown-bill-rises-to-330m. Prices in 2020 terms.

365 Information sourced from: https://itic-corp.com/blog/2017/05/hourly-downtime-tops-300k-for-81-of-firms-33-of-enterprises-say-downtime-costs-1m/.

366 Information sourced from internal discussions between HMT and the regulators. Estimate reflects a reasonable guess.

prevents firms from making payments to one another, this could lead to liquidity issues across the sector. If critical third-party disruption prevents customers or businesses from making payments, moreover, there could be impacts in the real economy. Since these effects are harder to monetise, the government has not incorporated them in this analysis.

16.68 As a result of this policy, the government assumes the likelihood of finance sector disruption incurring costs on this scale will fall. Since an incident involving widespread finance sector impacts following critical third-party disruption has not yet occurred, the probability of such an event is also difficult to evaluate. If the probability of disruption were to fall by a mere 3% points, however, the expected yearly benefit of the policy would be sufficient to outweigh costs over a 10-year appraisal period. For comparison, in an EU impact assessment of a similar proposal, a conservative 10% fall in the likelihood of disruption was assumed.[367] Due to the uncertainties around these figures, the government has ultimately chosen not to monetise these benefits in the final cost-benefit analysis. It is reasonable to assume, however, that the benefits from the policy will outweigh the costs.

*Greater levels of efficiency for financial services firms*

16.69 Aside from a reduction in the cost of critical third-party disruption, there are also likely to be indirect benefits from this policy. For example, owing to increased levels of assurance, usage of third parties by firms may rise. Since this is associated with efficiency as well as resiliency gains, finance sector output may rise.

**Assumptions, limitations and considerations**

16.70 It has not been possible to estimate how often a critical third party may experience problems and therefore the cost savings.

**Small and MicroBusiness Assessment (SaMBA)**

Number and distribution of businesses in scope of the regulation.

16.71 As set out above, HM Treasury estimates that around 15-20 entities in total will be designated as critical third parties under this regime via secondary legislation. Only businesses that have been designated by HM Treasury will fall into the scope of the regulation.

16.72 For an entity to be designated as a critical third party, HM Treasury would have to be satisfied that a failure in, or disruption to, the provision of the services that it provides to firms and financial market infrastructure (either individually or where more than one service is provided, taken together) could threaten the stability of, or confidence in, the UK financial system.

16.73 This requirement means that designated critical third parties will almost certainly be larger businesses such as major multinational cloud computing providers, whose systemic risk has already been identified by, for example, the Bank's Financial Policy Committee. While small and microbusinesses may provide important services to

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[367] Information sourced from: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52020SC0198&qid=1640091395473.

financial services firms, it is highly unlikely that a small or micro-businesses would be able to provide services which create the systemic risk which this policy aims to mitigate.

16.74 There is a remote possibility that a third-party provider offering very specialised services to the financial sector, such as back-office or niche technology services, could be designated as a critical third party. Although this scenario is unlikely, it is conceivable that such a third party could meet the criteria for a SMB.

Do the impacts fall disproportionately on small and microbusinesses?

16.75 The regulatory costs of this policy will only fall on those estimated 15-20 firms who are eventually designated by HM Treasury as critical third parties in accordance with the criteria set in legislation. Those decisions have not yet been made. But as set out above, the designated firms are highly likely to be large firms, such as multinational cloud computing providers, because of the nature of the designation criteria and the requirement that the firm could create financial stability risks.

16.76 In the unlikely scenario that a SMB is designated as a critical third party by HM Treasury, any impact on that small or microbusiness would depend on the regulators' rules and the way in which the regulators exercise their other powers in the regime. The regulators would consider whether it would be appropriate to mitigate the impact on SMBs if possible, in line with their general duty to regulate in a proportionate way.

16.77 The regulators have published a Discussion Paper on this topic and will formally consult on their rules after Royal Assent, and impacts of these rules, including on smaller firms, will be considered as part of their cost-benefit analysis in the usual way.

Could small and microbusinesses be exempted while achieving the policy objectives?

16.78 No. While unlikely, if a small or micro-business did meet the criteria, then it would be proportionate and in line with the regime's desired objectivity to bring the firm into the scope of this regime because of the systemic risk it could pose to the UK's financial system. If this did occur, a small or micro-business would be individually designated, and the regulation would only apply to that individual business.

16.79 However, as set out above, it is highly unlikely that a small or micro-business would meet the criteria to be designated as a critical third party.

Could the impact on small and microbusinesses be mitigated while achieving the policy objectives?

16.80 The impact on small and micro-businesses is expected to be zero given that they are highly unlikely to be designated. However, if a small or micro-business met the criteria, then it would be proportionate to apply to the regime to that business because of the impact it could have on the UK's financial system (that is, the aim of the policy would be to bring that specific business into the scope of the regulation).

16.81 The risk of a cost to a small or micro-business therefore can't be mitigated entirely but is highly unlikely to materialise because of the nature of the regime's designation criteria, as set out above.

Wider impacts on small and microbusinesses:

16.82 There will be no wider burdens on small or micro-businesses across the economy because only 15-20 designated entities will have to comply with the regulation, and as set out above, it is highly unlikely that a small or micro-business will meet the criteria for designation.

16.83 Within the financial services sector, small and micro-businesses could benefit from the verifiable increase in resilience which this policy aims to achieve, if they rely as a service user on a designated critical third party or another third party which has chosen to adopt the same standards. SMBs that are customers of firms who use critical third parties (e.g. business customers of a bank that uses a critical third party provider) will particularly benefit, due to a reduction in the risk of disruption to their services.

## Bank of England Levy

**Problem under consideration**

17.1 The Cash Ratio Deposit (CRD) scheme currently funds the Bank of England's (Bank) monetary policy and financial stability operations. The use of the CRD scheme as opposed to direct funding from government ensures the maintenance of central bank independence. Under the scheme, deposit-taking financial institutions (e.g. banks and building societies) (CRD payers) are required to place non-interest bearing deposits at the Bank. The Bank then invests these deposits in debt securities (currently only UK gilts), and uses the income earned from this investment to fund the costs of the Bank's monetary policy and financial stability operations.

17.2 Since the financial crisis, gilt yields have been significantly lower than expected. This has led to lower returns for the Bank than the last review of the CRD scheme in 2018 set out as the worst-case scenario. The projected shortfall of funding over the 2018-23 period is expected to reach £261 million, with the Bank's capital and reserves funding the shortfall. As a result of the shortfall the Bank did not make a dividend payment to HM Treasury in the year 2020/21 (as the sole shareholder of the Bank) as its loss-absorbing capital was below the target set in agreement with HM Treasury in 2018.[368]

17.3 The Bank sets out to deposit-takers how much they need to deposit to fund its operations. The total deposits required from CRD payers is projected to rise in size from £7.6 billion in 2018, to approximately £14 billion by 2023. Despite this, the CRD scheme has not provided predictable or reliable funding for the Bank falling below required levels since 2018, along with increased costs due to additional responsibilities. Therefore, the CRD scheme has resulted in significant uncertainty for CRD payers and the Bank.

**Rationale for intervention**

17.4 A review of the CRD scheme by the Bank of the CRD scheme in 2018 made the CRD scheme responsive to changes in gilt yields and to stabilise the income. The ratio is recalculated every six months to allow it to be more closely aligned to prevailing gilt yields in the market. However, gilt yields since 2018 have generally fallen below the downside scenario set out in the review, and have been subject to volatility. Consequently, while the yratio has adjusted every six months in response to changing market conditions, it has diverged from the actual yield on the Bank's portfolio.

17.5 This has led to a shortfall in the income raised by the Bank to fund its monetary policy and financial stability functions. In the governments 2021 review of the scheme, we set out that the projected shortfall of funding for the Bank's policy functions over the 2018-23 period is expected to reach £261 million. Alongside this, the scheme has resulted in cash ratio deposit sizes significantly higher than originally

368 This was the first time in available records this had happened.

forecast and created a lack of predictability for CRD payers as their contribution changes in line with gilt yields.

17.6 Depositing in the CRD scheme also represents an opportunity cost for firms as they are non-interest bearing and are not available for alternative use, such as investing into higher yielding assets. Firms will have the choice over how to invest and generate the income required to make the levy payment.

17.7 While gilt yields have subsequently risen and any new gilt purchases under the scheme may benefit from increased yields, the majority of the existing portfolio was purchased during the low yield environment of recent years. As such, the impact on income under the scheme is not immediate and potentially subject to volatility.

**Policy Objective**

17.8 The government's objective is to ensure that the Bank has a sustainable and independent funding model, funded by the banking industry, that meets the Bank's policy costs and ensures that the Bank is able to meet its statutory objectives.

**Description of Options Considered**

17.9 Option 0 (Do nothing) - If the CRD scheme were retained in its current form, and just the income target updated, the CRD portfolio would need to increase in order to attempt to generate the target income over the 2023-2028 period and could be subject to future changes in gilt yields. This would mean the Bank does not have a stable funding source for its policy functions, and there is continued uncertainty to payers over the size of their contributions to the scheme.

17.10 Option 1 (Preferred Option) - Replacing the CRD scheme with a direct funding arrangement in the form of a levy, introduced through primary legislation, is the preferred option. This would deliver a simpler, more transparent funding scheme for the CRD payers, releasing potential income opportunities for payers currently locked in unremunerated deposits. It would offer a more reliable way of providing funding that is sustainable in the long-term for the Bank's policy functions.

17.11 Option 2 (Non-preferred) - Recalibrate the CRD scheme. The CRD scheme could be retained and recalibrated through secondary legislation. This could involve updating the formulas that determine the size of CRD balances. Adjustments to the eligible liabilities threshold or definition of eligible institutions would change the distribution of costs of the CRD scheme, but would not address the challenges relating to its performance and unpredictability.

**Outline of preferred policy**

17.12 Changing the scheme to a levy will offer a simpler and more efficient way of generating an income for the Bank. It would allow the cost to payers to be assessed directly rather than inferred, as with CRD. This would be a transparent and an easily identifiable cost for firms.

17.13 A levy offers a more efficient means of funding the Bank's policy functions. The Bank and HM Treasury have agreed in their Memorandum of Understanding that in the event that the Bank's loss-absorbing capital is reduced to a level that is significantly

below its capital target, the Bank will receive a capital injection from HM Treasury in order to return the Bank's capital to target and to ensure that the Bank can maintain its ability to achieve its objectives.

17.14 Replacing the CRD scheme with a new levy will ensure that the Bank receives income in line with its forecast policy expenditure and conserve its current capital position. The overall objective of financial institutions funding the Bank's policy costs will not change, however the method by which this will happen will.

17.15 The Bill will require the current cohort of CRD payers to pay a levy in proportion to their eligible liability base. This would mean that each payer will contribute the same proportion of the total levy as they do to the deposits under the CRD scheme. This levy will change the way the burden falls on payers, since they will pay their contribution directly instead of depositing large sums in an unremunerated account. But the levy will not represent an increased burden on payers than the CRD scheme.

17.16 Deposit-taking financial institutions will be eligible to pay the levy, and those holding a deposit base above a threshold, currently £600m in the CRD scheme, will be required to pay the levy as they have been required to place cash ratio deposits with the Bank. It is expected that the same institutions that contribute to the CRD scheme will contribute to the new levy. The policy rationale for this is the link between the size of a financial institution's liabilities and its potential impact on the Bank's financial stability functions.

17.17 To simplify the levy for payers, the new levy has been developed with consideration of the PRA and FMI charges, which funds the Bank's regulatory activities, and the CRD scheme. The Bank presently charges both deposit-takers for prudential regulation/supervision as well as financial market infrastructure for regulation/supervision. This Financial Services and Markets Bill will repeal the current provisions in the Bank of England Act 1998 and replace it with the levy.

17.18 Under a levy-based arrangement, the Bank would determine which of its monetary policy and financial stability policy functions it intends to fund (in whole or part) by the levy. The Bank would then determine the amount of levy it reasonably considers it requires in connection with the funding of those functions. The intention is for the annual levy to match the expected expenditure of its monetary policy and financial stability policy operations. The Bank's policy costs will be approved each year by its Court of Directors as part of the Bank's annual budget setting processes. This will be discussed with HM Treasury as part of the existing scheduled Bank budget meetings. Each year, before applying the levy, the Bank will notify industry on its plans for the levy.

17.19 The Bank will determine the amount of levy an eligible institution would have to pay in accordance with regulations made by HM Treasury. It is intended that regulations will allocate the anticipated levy requirement across the eligible firms, for each institution proportionate to their eligible liability base, setting out the formula and ratio for how this will be applied. This will be a continuation of how the CRD scheme currently operates. The proposed minimum liability base is £600 million. The Bank will then notify firms of the amount of the levy they are liable to pay.

17.20 As happens with other cost recovery schemes, a mechanism would exist for adjusting subsequent years' levies to take account of under or overspends, following the finalisation of accounts. The Bank would publish a detailed breakdown of its costs for the year, deviations from budget and income from the levy in its Annual Report and Accounts and/or the annual notification.

17.21 HM Treasury will continue to monitor the effectiveness of the funding model used to meet the Bank's policy costs and will conduct a further formal review within at least five years of secondary legislation being introduced and publish a report in respect of that review. As part of HM Treasury's five-yearly review of the levy scheme, consideration of the Bank's approach to levying policy costs, including its approach to setting the annual aggregate costs will be included.

**Methodology**

17.22 The costs and benefits are being compared to a counterfactual whereby the CRD scheme remains the way that the Bank's policy costs are funded.

17.23 The shortfall being left by the CRD scheme, and that the Bank is currently meeting that shortfall from its capital base, is not the result of policy intention. Therefore, the assessments of the costs and benefits of the CRD scheme and the proposed levy assume that both funding schemes fully recover the Bank's policy costs.

17.24 As outlined below, it is expected that the administrative and operational costs of operating and transitioning to the new levy to be negligible for both financial firms and the public sector, compared to the counterfactual of an amended CRD scheme remaining in place.

17.25 Further details will be set out in the secondary legislation that is enabled by the Bill. HM Treasury will provide a further impact assessment in each instance of a where it makes such secondary legislation. However, to inform an assessment of the Bill the government has set out the possible costs and benefits. It is important to note however that the below costs and benefits are illustrative and any costs and benefits to firms will be contingent on the exact nature of the secondary legislation.

17.26 At the point of secondary legislation, and in line with the government's approach to better regulation under the Better Regulation Framework, HM Treasury will make efforts to further consult on and understand the potential further impacts of this measure, including through appropriate stakeholder engagement. More detailed qualitative and quantitative cost-benefit analyses are expected to be covered in the IAs accompanying the relevant secondary legislation enabled by the Bill. HM Treasury will also engage with the RPC, prior to the submission of IAs produced to accompany future secondary legislation where appropriate.

Population within scope of this proposal

17.27 Firms currently paying into the CRD scheme will be the same cohort of payers for the new levy. Eligible institutions will be deposit-taking institutions (e.g. banks and building societies) authorised under the Financial Services and Markets Act 2000. At present, banks and building societies with a deposit base of over £600m are required to place a cash ratio deposit with the Bank. From a group of approximately 345

banks and building societies that fall into the scheme's remit, as of June 2021 approximately 159 institutions have a liability base over £600m and therefore are required to pay into the CRD scheme. This is expected to remain similar.

17.28 Stakeholder engagement in advance of the formal consultation indicated that payers would be broadly supportive of HM Treasury's proposals of replacing the CRD scheme with a levy of the same cohort of payers. Most responses to the 2018 consultation suggested that a levy would be an appropriate alternative funding arrangement. The responses to the 2021 consultation also indicated that industry is broadly supportive of the proposal for a new levy.

**Policy Costs**

Transitional costs to the payers

*The levy*

17.29 The cost to industry is the levy payment that eligible firms are required to make to the Bank to pay for the Bank's policy costs. Given that the objective under both the CRD scheme and the levy is the full recovery of the Bank's policy costs, a firm's levy payment is therefore equivalent to its indirect contribution to the Bank's policy costs through the CRD scheme meaning that there is no net cost associated with this change. The size of a firm's contribution under the levy would be, like the CRD scheme, proportional to their eligible liability base. The levy contribution would appear as recurring cost that would affect payers' profit and loss accounts as an administrative expense.

17.30 The costs of the Bank's policy functions are higher than forecasted at the review of the CRD scheme in 2018. The Bank's projected policy costs for 2021-2022, which would in future years be recovered through the levy, are £203.6 million. The Bank is now beginning to implement a multi-year budget planning and prioritisation process. The Bank has not forecast its policy costs for future years.

17.31 Based on a total levy of £203.6 million, the mean and median relative weighting for each payer's contribution to the levy is set out in Table 17.A:

Table 17.A: Mean and Median payments for CRD payers

| | **Mean** | **Median** |
|---|---|---|
| **All payers (153 in total)** | £1,330,718.95 | £209,755.27 |

| Top 20 payers | £7,876,703.08 | £4,370,276.83 |
|---|---|---|
| Rest of payers (133 in total) | £346,360.44 | £151,393.23 |

*Risk-weighted assets*

17.32 CRDs do not contribute towards the calculation of risk-weighted assets. Alternative investments could therefore increase a firm's risk weighted capital requirements, requiring adjustments to be made to calculations of returns for firms that are constrained by this measure. This depends on the individual capital position of firms, and what they choose to do with the returned CRD balances. The overall impact would be expected to be minimal given the size of CRD balances relative to total assets.

**Policy Benefits**

Transitional benefits for payers

17.33 The transition to a levy will allow the return to payers of funds that have previously been deposited under the CRD scheme.

Ongoing benefits

*Benefits to HM Treasury – Lower likelihood of recapitalisation*

17.34 In the event that the Bank's capital falls below a floor level agreed between the Bank and HM Treasury. HM Treasury would need to provide the Bank with a capital injection to return the Bank's capital to its target level. The replacement of the CRD scheme with the proposed levy would ensure that recapitalisation of the Bank by HM Treasury becomes less likely given the increased stability and certainty of funding.

*Benefits for the Bank - Certainty and stability in funding*

17.35 The proposed levy would represent a more stable income source and would ensure that the income received by the Bank is in line with its forecast expenditure for its policy functions. The Bank would not have to fund the income shortfall through its own capital and reserves and risk running an overall deficit. This would also provide increased certainty for the Bank.

17.36 In contrast to the CRD scheme, which has already seen significant increases in the ratio (and could become more volatile if further amendments to the scheme were made to stabilise income), a levy would remain relatively stable over time and would provide an income stream that is sustainable over the long-term.

*Benefits for payers - Efficiency and reduced opportunity costs*

17.37 The Bank invests cash ratio deposits in gilts with a maturity between 3 and 22 years and aims to match the issuance profile of the UK Debt Management Office in this

range. This results in average maturity of around 8 years. Under the existing CRD scheme the primary cost to firms is the foregone income, the opportunity costs on the deposits they are required to place in unremunerated accounts. Over time, a levy would be more cost effective than the CRD scheme if CRD payers are to be able to earn a higher risk-adjusted return than that available from investing in 8-year gilts. Deposit-takers as a group could be expected to be able, over time, to earn returns in excess of those available on gilts, implying that a levy regime should be more efficient for payers. CRD payers would have the option of continuing to invest in gilts (as currently happens with their CRD deposit) or invest in a broader range of assets in order to earn the required income to make the levy payment.

17.38 Estimating payers' foregone income from placing cash ratio deposits with the Bank is challenging as it requires assumptions around forward gilt yields, the Bank's costs and the behaviour of, and choices available to, firms who have these deposits returned to them. However, for illustrative purposes, firms may choose to invest their returned CRD balances in longer dated gilts, rather than the average investment portfolio of the CRD scheme of 8-year gilts. Replacing the CRD scheme with a levy could allow payers to capture foregone income currently contained in their cash ratio deposits. Consultation responses noted that payers may choose to use their funds in a variety of other ways, which would generate differing levels of income as a result.

*Simplicity and transparency*

17.39 Replacing CRD with a levy-based scheme would result in a direct cost that is straightforward for payers to assess. Most responses to the 2018 consultation mentioned that the CRD scheme is uncertain and overly complex. A levy-based scheme will change the way the burden falls on payers, since they will pay directly and will no longer have to deposit large sums in an unremunerated account. This should offer a simpler and more efficient way of generating a given target income. This also allows the cost to payers to be assessed directly rather than inferred, as with CRD.

*Certainty*

17.40 Under the CRD scheme, payers face costs from the uncertainty of the CRD balance they are required to maintain. Responses to the 2021 consultation noted that a levy's pre-defined cost would allow payers to plan ahead without constraining their balance sheets. Transitioning to a levy provides increased certainty.

**Assumptions, limitations and considerations:**

17.41 It is assumed that banks and building societies that currently pay into the CRD scheme, will have access to a broad range of options to invest funds currently contained in cash ratio deposits.

**Small and MicroBusiness Assessment (SaMBA)**

Number and distribution of businesses in scope of the regulation. Do the impacts fall disproportionately on small and microbusinesses?

17.42 The measure replaces the existing Cash Ratio Deposit (CRD) scheme, which is currently only paid by banks and building societies with a deposit base above a threshold, currently set at £600m. The expectation is for the new levy to be funded by the same cohort of payers. As of June 2021 approximately 159 eligible institutions had a liability base over £600m and therefore were required to pay into the CRD scheme. Because of the size of firms (in terms of number of employees and/or turnover) who have a liability based of over £600m, there are no small- and micro-businesses in this cohort. Therefore, there are no SMBs in scope of the levy at present and this is not expected to change in the future. This also means that there are no disproportionate costs to consider for SMBs.

Could small and microbusinesses be exempted while achieving the policy objectives or could the impact be mitigated while achieving the policy objectives?

17.43 As there are no small- and micro-businesses who hold deposits of over £600m and are therefore in scope of the levy, there is no need to exempt SMBs or consider additional mitigations.

Wider impacts on small and microbusinesses

17.44 The levy offers a more efficient means of funding the Bank's policy functions of monetary policy and financial stability, ensuring these important functions have a stable funding mechanism into the future and providing a benefit for the whole UK economy, including SMBs operating in the UK.

## Disciplinary Action Against Formerly Authorised Persons

**Problem under consideration**

18.1 Any firm carrying out a regulated activity must, subject to certain exemptions, be regulated by the Financial Conduct Authority (FCA), and if necessary, the Prudential Regulation Authority (PRA):

a. The FCA is the conduct regulator for the financial services sector. Amongst other things, it sets rules that financial services firms must adhere to. It is responsible for the conduct of around 51,000 financial services firms, the prudential regulator for 49,000, and sets specific prudential standards for 18,000 in the UK.

b. The PRA is responsible for the prudential regulation of banks, building societies, credit unions, insurers, and major investment firms. It regulates around 1,500 firms.

18.2 The Financial Services and Markets Act 2000 (FSMA) includes a general prohibition on persons carrying out financial services activities unless they have the appropriate authorisation. The activities subject to the general prohibition are specified as regulated activities under the Regulated Activities Order (RAO). Regulated Activities tend to be the core activities of financial services which generally relate to offering financial services to a third party e.g. consumers that is not itself a financial services firm. In order to carry out a regulated activity, a firm must apply for authorisation as an 'authorised person', meet certain threshold conditions, and must comply with the relevant rules and requirements set out by the FCA in its Handbook and Principles for Businesses (and any applicable PRA rules dual-regulated).

18.3 Where authorised firms breach these rules, the regulators can sanction firms by, for example, suspending their authorised status or imposing a public censure or a financial penalty. They can also require the payment of redress and instigate criminal prosecutions. In 2021, the FCA fined eleven firms a total sum of £303 million and the PRA fined two firms a total sum of around £50 million.

18.4 However, except in some specific circumstances the FCA and the PRA are unable to take disciplinary action against firms which are no longer authorised, if they committed misconduct whilst they were authorised.

18.5 Currently, if the FCA and the PRA have concerns about the conduct of a formerly authorised firm while it was authorised, they can:

a. Require information and documents from the firm, with a view to deciding whether to commence an investigation into individuals who were employed by the firm when it was authorised;

b. Take action against individuals if it is found, after that investigation, that they were knowingly involved in the firm's misconduct or otherwise breached the regulators' applicable rules.

18.6 This creates a risk of regulatory arbitrage which may see firms apply to cancel their authorisation if they believe that they are going to be subject to misconduct

proceedings, allowing them to potentially avoid disciplinary action by cancelling their authorisation before their misconduct is identified.

18.7 There have been instances where the FCA or the PRA have maintained the authorisation of firms that were under investigation for misconduct, in order to maintain their ability to sanction them following the outcome of the investigation. This is suboptimal for consumers, as it requires firms to remain authorised (albeit with significant restrictions) and remain on the FCA's Register when it might be preferable for them to cease being authorised. This can also result in unnecessary supervisory resources being used on these firms as they continue to be authorised and subject to the requirements to, amongst other things, submit regulatory returns, when the public interest might be better served by cancelling their authorisation.

**Rationale for intervention**

18.8 The government therefore proposes to amend the law to allow the FCA and the PRA to take action against firms that are no longer authorised, for misconduct while they were authorised. This will remove the risk that firms are able to avoid sanctions by applying to cancel their authorisation before the FCA and/or the PRA become aware of any misconduct.

18.9 It will reduce potential confusion for consumers in relation to a firm that continues to be authorised solely to ensure the regulators are able to sanction them following the outcome of an investigation. This measure will also reduce the supervisory resource needed to continue to have oversight of such firms.

**Policy Objective**

18.10 The policy objective is to ensure firms that commit misconduct are subject to appropriate sanctions, and to deter firms from committing misconduct by providing certainty that the FCA and the PRA can take action against them even if they are no longer authorised.

**Description of Options Considered**

18.11 Option 0: Do Nothing - the regulators would remain unable to take action against formerly authorised firms.

18.12 Option 1: (Preferred Option) - The government will give the FCA and the PRA the power to take action against formerly authorised firms for misconduct while they were authorised.

**Outline of preferred policy**

18.13 The government will make amendments to FSMA to allow the FCA and the PRA to apply their disciplinary powers and power to require the payment of compensation to firms that are no longer authorised for misconduct while they were authorised. This will apply to firms who become unauthorised on or after the introduction of the Bill.

18.14 Specifically, this measure would allow the FCA and the PRA to:

a. Appoint a person to carry out an investigation into potential misconduct (under s.168 FSMA)

b. Publicly censure (under s.205 FSMA)

c. Issue a financial penalty (under s.206 FSMA)

d. Require the payment of compensation to victims of misconduct (under s.384 FSMA)

18.15 The use of these powers by the regulators will be subject to the same processes and safeguards as the use of these powers in relation to authorised firms. The FCA's decisions to use its disciplinary powers are overseen by a committee of the FCA's Board, the Regulatory Decisions Committee (RDC). The RDC is separate from the FCA's Enforcement Division. The PRA has an equivalent to the RDC called the Enforcement Decision Making Committee (EDMC). Where the RDC or EDMC is considering whether to take action against a firm, the firm is entitled to make written and oral representations before a decision is made. A firm may then refer that decision to the Upper Tribunal, which is completely independent of the FCA and the PRA.

**Methodology**

18.16 The FCA and the PRA have provided an estimate of the additional costs they may incur as a result of this change that will be passed on to affected firms. This estimate is based on the number of enforcement cases the regulators conduct per year, the cost of investigating and enforcing these cases, and how many are subsequently appealed to the Upper Tribunal.

18.17 There are no transitional (i.e. familiarisation) costs associated with this policy, as authorised firms already need to comply with the relevant regulatory rules.

Population within scope of the proposal

18.18 This measure would apply to any firms currently or previously authorised under FSMA that have committed misconduct whilst authorised, but are no longer authorised or have their authorisation removed in future. This will apply to firms who become unauthorised on or after the introduction of the Bill.

18.19 In 2021, 4,018 firms applied to the FCA and 43 applied to the PRA for the cancellation of their FSMA authorisation. Both regulators anticipate only a fraction of 1% of these firms would be affected by this amendment.

**Policy Costs**

Ongoing costs to business

*Fines*

18.20 The FCA has estimated an annual increase in FCA fines resulting from this measure at £250,000 for firms that have committed misconduct while they were authorised. The PRA does not anticipate a material increase in fines.

*Cost of investigations*

18.21 The FCA estimates that the additional annual cost resulting from this measure will be £75,000 per year in terms of the additional enforcement activity. The PRA does not anticipate a material increase in the cost of investigations. Given that enforcement costs are deducted from financial penalties, which are then remitted to HM Treasury, firms who do not breach the rules should not see an increase in costs as a result of the proposed change.

*Additional cases referred to the Upper Tribunal*

18.22 As set out above, firms can contest the outcome of disciplinary action via the Upper Tribunal. As this measure may increase the number of enforcement cases, there is the potential for more enforcement cases to be referred to the Upper Tribunal. The FCA and the PRA estimate that one additional case may be referred to the Upper Tribunal every 12 years.

**Policy Benefits**

*Improved conduct of financial services firms*

18.23 Extending the scope of the FCA and the PRA's ability to take disciplinary action will act as a deterrent to firms considering committing misconduct as it will make it clear that there could be enforcement action taken in relation to that misconduct even though the firm has had its authorisation removed. A reduction in such potential misconduct would mean a reduction in harm to users of financial services, which in turn may give individuals and businesses greater confidence in the financial services sector. There would therefore be benefits to the sector as a whole and the wider economy.

*Improved regulatory system*

18.24 Closing this loophole, which creates potential opportunities for firms that have committed misconduct to escape sanctions, will ensure that the UK's financial services regulatory system is more robust and effective in preventing misconduct and holding firms accountable for misconduct.

*Greater income for HM Treasury from fines*

18.25 As noted above, the FCA estimates that there will be an additional £250,000 per year from fines, which would be given to HM Treasury after enforcement costs have been deducted.

**Small and MicroBusiness Assessment (SaMBA)**

18.26 This measure applies to all businesses (including small and microbusinesses) and persons that have committed misconduct whilst authorised but have ceased to be authorised on or after 20 July 2022.

18.27 The FCA and the PRA do not exempt small or microbusinesses from disciplinary action. Therefore, where a firm is a small or microbusiness which has committed

misconduct and ceased to be authorised on or after 20 July 2022, this measure will enable the FCA and PRA to take action against them in the same way as all other firms. The government does not consider it appropriate to exempt small or microbusinesses from disciplinary action taken by the regulators.

18.28 When calculating the size of financial penalties, the regulators factor in the firm's relevant revenue (amongst other things), meaning fines are generally proportionate to the size of the firm and do not disproportionately impact SMEs.

Number and distribution of businesses in scope of the regulation.

18.29 This measure does not directly impose any new requirements or costs on businesses, including small and microbusinesses. Rather, it allows the FCA and the PRA to take disciplinary action against firms who have committed misconduct whilst they were authorised, and who have ceased to be authorised on or after 20 July 2022.

18.30 The FCA estimates that this measure may result in one extra case of disciplinary action per year, however it is not possible to predict the likelihood of this relating to a firm that is classed as a small or microbusiness. The PRA does not anticipate a material increase in cases of disciplinary action as a result of this measure. Therefore, at most, this measure is estimated to result in disciplinary action being taken against one additional small or microbusiness per year, which would be the result of that business having committed misconduct.

18.31 Small and microbusinesses will benefit from this measure to the extent that they are users of financial services. This is because the measure will promote high standards of conduct amongst providers of financial services by ensuring the regulators can take decisive regulatory action to punish misconduct and prevent harm to users of financial services. Assuming that all small and microbusinesses are users of financial services to some extent (through having a bank account, for example), HM Treasury estimates, based on ONS data on the number of small and microbusinesses in the UK, that up to 2,712,955 small and microbusinesses could potentially benefit from the enhanced standards of conduct brought about by this measure (i.e. 100% of the UK's small and microbusinesses). That is, all small and microbusinesses in the UK may benefit to some extent from the higher standards of conduct in financial services that this measure will promote, assuming that all small and microbusinesses are users of financial services to some extent.

Do the impacts fall disproportionately on small and microbusinesses?

18.32 This measure does not directly impose any new requirements or costs on businesses, including small and microbusinesses. The measure allows the FCA and the PRA to take disciplinary action against all businesses, including small and microbusinesses, that have committed misconduct whilst authorised but who have ceased to be authorised on or after 20 July 2022. Misconduct can be committed by firms of any size.

18.33 Along with other users of financial services, small and microbusinesses will benefit from this measure. This is because the measure will promote high standards of conduct amongst providers of financial services by ensuring the regulators can take decisive regulatory action to punish misconduct and prevent harm to users of

financial services. Assuming that all small and microbusinesses are users of financial services to some extent (through having a bank account, for example), based on ONS data on the number of small and microbusinesses in the UK, that 2,712,955 small and microbusinesses could potentially indirectly benefit from the enhanced standards of conduct brought about by this measure.

Could small and microbusinesses be exempted while achieving the policy objectives?

18.34 No, this measure applies to all businesses, including small and microbusinesses, that have committed misconduct whilst authorised but who have ceased to be authorised on or after 20 July 2022.

18.35 The FCA and the PRA do not exempt small/microbusinesses from disciplinary action. The government does not consider it would be appropriate to do so for this measure, as it is important that the regulators can take disciplinary action against firms that have committed misconduct, regardless of their size. Ensuring the regulators can take disciplinary action against all regulated firms, regardless of their size, is necessary to ensure they can advance their objectives, for example by ensuring all firms are deterred from committing misconduct.

Could the impact on small and microbusinesses be mitigated while achieving the policy objectives?

18.36 Appropriate mitigations are already provided for in that the regulators already take a proportionate approach to disciplinary action, which takes account of a firm’s size. Both the FCA Handbook and the PRA’s Statement of Policy on its approach to enforcement state that the regulators’ approaches to enforcement action, including financial penalties, are proportionate and take into account the size and resources of the firm in question.[369] As such, when calculating the size of financial penalties imposed on firms that have committed misconduct, the regulators already factor in the firm’s relevant revenue (amongst other things), meaning fines are generally proportionate to the size of the firm.

Wider impacts on small and microbusinesses.

18.37 The measure allows the FCA and the PRA to take disciplinary action against all businesses, including small and microbusinesses, that have committed misconduct whilst authorised but who have ceased to be authorised on or after 20 July 2022. This will benefit all users of financial services, including the UK’s 2,712,955 small and microbusinesses, by promoting higher standards of conduct in financial services. These higher standards will be promoted by ensuring the regulators are able to take action against firms who have committed misconduct even when they are no longer authorised, thereby providing a greater deterrent to firms considering committing misconduct.

[369] See https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/statement-of-policy/2019/the-pras-approach-to-enforcement-statutory-statements-of-policy-and-procedure-sop-sep-21.pdf?la=en&hash=A0FFD6CF99BD205D1F8464A3CE29996CE6511FCD and https://www.handbook.fca.org.uk/handbook/DEPP/6.pdf

## Financial Conduct Authority (FCA)/Financial Ombudsman Service/Financial Services Compensation Scheme (FSCS) cooperation on wider implications issues

**Problem under consideration**

19.1 The Financial Conduct Authority (FCA) is the conduct regulator for the financial services sector. A key part of its role is to set rules that financial services firms must adhere to. It is responsible for the conduct of around 51,000 financial services firms, the prudential regulator for 49,000, and sets specific standards for 18,000 in the UK.

19.2 The Financial Ombudsman Service is an alternative dispute resolution service for financial services complainants such as consumers and smaller businesses which have a complaint about a financial services firm. The Financial Ombudsman Service also deals with complaints about claims management companies. It is provided free to complainants at the point of use. Its statutory purpose is to provide for the resolution of disputes quickly and with minimum formality by an independent person.

19.3 The Financial Services Compensation Scheme (FSCS) exists to provide protection for eligible customers of financial services firms authorised by the FCA. It protects consumers that incur financial losses when authorised firms are unable, or likely to be unable, to pay claims against them.

19.4 The Money and Pensions Service (MaPS) provides free, impartial debt advice, money guidance and pension guidance to members of the public. The Pensions Regulator (TPR) is the UK regulator of workplace pension schemes.

19.5 Whilst the FCA, the Financial Ombudsman Service and the FSCS each have distinct statutory roles, the work of each organisation will often be relevant to, or have implications for, the others. Given this interaction, the FCA and the Financial Ombudsman Service are subject to a statutory requirement to take such steps as they consider appropriate to cooperate with each other in the exercise of their functions. The FCA and the Financial Ombudsman Service are required by statute to maintain a memorandum of understanding (MoU) describing how they intend to comply with this requirement to cooperate. The FSCS and the FCA are also subject to a statutory requirement to cooperate with each other and maintain an MoU describing how they do so.

19.6 In some cases, issues being considered by the FCA, the Financial Ombudsman Service or the FSCS will have significant implications for issues within the responsibility of the others, and/or for the wider financial services sector. For example, if the Financial Ombudsman Service receives complaints from a large number of consumers in relation to potential wide-spread misconduct (e.g. mis-selling) this may have implications for the FCA’s regulation or supervision of those financial services firms, or may lead to claims for FSCS compensation in the event that firms fail. These authorities may therefore need to cooperate to determine the optimal way of delivering redress to the affected complainants. Similarly, the development of new regulatory rules by the FCA could have implications for the number and nature of complaints brought to the Financial Ombudsman Service, for example if they impose

significant new requirements on firms. When issues with wider implications emerge, it is beneficial for the organisations to work together to ensure timely, collaborative discussions to determine the most appropriate approach to managing such issues.

**Rationale for intervention**

19.7 The government wants to support and ensure proactive and effective cooperation between the FCA, the Financial Ombudsman Service and the FSCS on issues with wider implications, and ensure that a framework is maintained to achieve this cooperation. The government also wants to ensure that this cooperation includes other bodies, such as MaPS and TPR, where appropriate. Such a framework has already been launched on a voluntary basis, and the government wishes to put it on a statutory footing to ensure it endures over time. This framework includes procedures for discussing issues which are considered to have wider implications, and agreeing an appropriate approach to managing them, and will helpfully supplement the existing MoUs that exist between the FCA, the Financial Ombudsman Service and the FSCS.

**Policy objective**

19.8 The government wishes to promote the timely, transparent, and robust management of issues with wider implications. This will be achieved by placing a duty on the FCA, the Financial Ombudsman Service and the FSCS to cooperate on wider implications issues, along with a requirement to publish a statement of policy setting out how they will do so. There will also be provision for the FCA, the Financial Ombudsman Service and the FSCS to consult other bodies (such as MaPS and TPR) where appropriate.

**Description of Options Considered**

19.9 Option 0 (Do nothing) - If the government did nothing, the existing framework between FCA, the Financial Ombudsman Service and the FSCS for cooperation on wider implications issues (which also includes MaPS and TPR) would operate on a voluntary basis. There is a risk that this option would be unsuccessful in the long-term, for example if the framework was not followed by the authorities or if it fell away over time, for example due to other requirements being prioritised. The FCA and the Financial Ombudsman Service have previously sought to introduce voluntary mechanisms to improve cooperation on wider implication issues which did not endure.

19.10 Option 1 (Preferred Option) - the introduction of a statutory duty for the FCA, the Financial Ombudsman Service and the FSCS to cooperate on wider implications issues and maintain a framework setting out how they will do so, which provides for engagement with other organisations (such as MaPS and TPR) where appropriate. This would promote effective cooperation on wider implications issues and ensure that there is a transparent framework for delivering this cooperation which endures over time. The inclusion of requirements to put in place arrangements for stakeholders to provide representations on their compliance with the duty, and to report annually on compliance with the duty and any representations from

stakeholders, would increase transparency and the effectiveness of stakeholder engagement.

**Outline of preferred policy**

19.11 The government intends to extend the existing cooperation obligations between the FCA and the Financial Ombudsman Service, and the FCA and the FSCS, by introducing a specific duty to cooperate on issues with wider implications. This will be supplemented by requirements to maintain a framework setting out how they will do so, to put in place arrangements for stakeholders to provide representations on compliance with the duty, and to report annually on compliance with the duty and any representations received. The matters with wider implications covered by the framework include those where it appears that either::

a. Activities by one or more financial services firms give rise to (or could give rise to) common interest questions concerning how members of the framework individually or collectively might best respond, given their respective statutory roles and functions; or

b. Activities by one or more of the members may have or could have an impact on the activities of another member, for example, if general expectations of firms in a relevant area change because of changes to the regulatory framework, supervisory action by the regulators, or other activities such as trends or issues in the Financial Ombudsman Service's or the FSCS's casework.

19.12 This measure is outcomes-focused, so does not prescribe the process for how the FCA, the Financial Ombudsman Service and the FSCS should implement the duty to cooperate or the framework. However, the measure will require the FCA, the Financial Ombudsman Service and the FSCS to consult other bodies (such as MaPS and TPR) where an issue with wider implications concerns these bodies, or where the FCA, the Financial Ombudsman Service or the FSCS otherwise considers that it would be appropriate.

**Methodology**

19.13 These changes will indirectly benefit all firms within the jurisdiction of one or more of the authorities through improved cooperation between the authorities, leading to better regulatory outcomes. No firms will be directly impacted by these changes.

**Policy Costs**

Ongoing costs

*Cost of maintaining the framework*

19.14 The FCA, the Financial Ombudsman Service and the FSCS (along with MaPS and The Pensions Regulator) are already operating a wider implications framework on a voluntary basis. Additional costs associated with ensuring the authorities (and the framework) comply with the government's proposals are judged to be negligible.

**Policy benefits**

Ongoing benefits

*Improved coordination between the FCA, the Financial Ombudsman Service and the FSCS*

19.15 Introducing a duty to cooperate on wider implications issues should further improve cooperation between the FCA, the Financial Ombudsman Service and the FSCS. This duty will reinforce the existing arrangements for effective discussion and information sharing on wider implications issues, and collaborative analysis of how best to address them. This collaboration will contribute to better outcomes for consumers, small businesses and the financial services industry.

19.16 Requiring a framework for cooperation to be maintained will also ensure the durability of the framework, compared to it being operated on a voluntary (non-statutory) basis. There would be an ongoing benefit derived from improved, enduring cooperation between the FCA, the Financial Ombudsman Service and the FSCS, in terms of the more efficient and effective resolution of issues with wider implications. This is likely to ensure continued benefits to all relevant stakeholders, including the regulators, firms, and consumers. Sustained improved cooperation over time would also lead to more effective resolution of complaints by firms themselves, and by the Financial Ombudsman Service, which could in turn reduce the Financial Ombudsman Service's funding requirement.

**Assumptions, limitations and considerations**

19.17 N/A

**Small and MicroBusiness Assessment (SaMBA)**

Population within scope of this policy proposal

19.18 This measure applies to the FCA, the FOS and the FSCS. No businesses are directly in the scope of the regulation, and this measure does not impose any new costs or requirements on businesses.

19.19 This measure will generate benefits for a number of businesses insofar as some are regulated by the FCA, and certain complaints or claims from small and microbusinesses will fall within the jurisdiction of the FOS and the FSCS respectively, meaning these businesses may benefit from enhanced cooperation between the authorities. In addition, 99% of small businesses are able to bring complaints about financial services firms to the FOS as users of financial services.[370]

19.20 The FCA currently regulates over 50,000 firms. Based on turnover data, out of 38,599 reporting firms, 34,533 (89%) can be classified as 'small' (turnover of less than or equal to £10.2 million). This data is based on the 2021 financial end for FCA regulated firms with an active status and where the data is stored and accessible from the FCA's data lake. It does not cover data reported by firms who no longer have an active status. Where there are gaps, the FCA have looked to try to fill these using information from a survey conducted in response to the COVID-19 situation,

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[370] See https://sme.financial-ombudsman.org.uk/complain/can-help

though it should be noted that not all firms completed this. Using 89% as a proxy, the government anticipates that approximately 44,500 SMBs are regulated by the FCA.

19.21 It is expected that all of these businesses could potentially benefit to some extent from the increased coordination between the authorities that this measure will promote (i.e. 100% of the small and microbusinesses regulated by the FCA). This is because greater regulatory coordination can reduce the overall regulatory burden on industry and promote the resolution of wider implications issues in a more efficient way.

19.22 There may also be wider, less direct benefits from this enhanced coordination for all of the UK's small and microbusinesses, to the extent that they are users of financial services. For example, regulated firms providing financial services may experience a reduced overall regulatory burden, generating cost savings that may be passed on to users of financial services. Assuming that all small and microbusinesses are users of financial services to some extent (through having a bank account, for example), these wider benefits could potentially accrue to the UK's 2,712,955 small and microbusinesses, based on ONS data on the number of small and microbusinesses in the UK.[371] That is, all (100%) small and microbusinesses in the UK may benefit to some extent from the greater regulatory cooperation that this measure will promote, assuming that all small and microbusinesses are users of financial services to some extent.

Do the impacts fall disproportionately on small and microbusinesses?

19.23 No, this measure will not impose any costs or requirements on small or microbusinesses. The FCA, the FOS and the FSCS (along with the Money and Payments Service and The Pensions Regulator) are already operating a wider implications framework on a voluntary basis. Additional costs for these authorities associated with ensuring the authorities (and the framework) comply with the government's proposals are judged to be negligible. Small and microbusinesses that are users or providers of financial services will benefit from the enhanced cooperation between the authorities that this measure will bring about. This is because greater regulatory coordination can reduce the overall regulatory burden on providers of financial services and promote the resolution of wider implications issues in a more efficient way. Amongst other things, this may result in cost savings for providers of financial services which may be passed on to their customers, including small and microbusinesses.

Could small and microbusinesses be exempted while achieving the policy objectives?

19.24 This measure does not introduce any new costs or requirements for small and microbusinesses, only benefits, so an exemption would not be appropriate. There would not be merit in excluding issues pertaining to small and microbusinesses from the duty of cooperation being introduced by this measure, and in fact it would be

[371] See https://www.ons.gov.uk/businessindustryandtrade/business/activitysizeandlocation/bulletins/ukbusinessactivitysizeandlocation/2021

detrimental, as it would mean small and microbusinesses would not benefit from the enhanced cooperation between the authorities that this measure will bring about. This enhanced cooperation has the potential to, amongst other things, lead to cost savings for providers of financial services (including small and microbusinesses) by reducing the overall regulatory burden, and these savings may be passed on to users of financial services (including small and microbusinesses).

Could the impact on small and microbusinesses be mitigated while achieving the policy objectives?

19.25 This measure does not introduce any new costs or requirements for small and microbusinesses.

Wider impacts on small and microbusinesses.

19.26 The ongoing benefits of this measure will also apply to small and microbusinesses as much as larger firms. As users and providers of financial services, these businesses will benefit from the improved cooperation brought about by these proposals. This is because greater regulatory coordination can reduce the overall regulatory burden on providers of financial services and promote the resolution of wider implications issues in a more efficient way. Amongst other things, this may result in cost savings for providers of financial services which may be passed on to their customers, including small and microbusinesses.

## Financial Services Compensation Scheme (FSCS)

**Problem under consideration**

20.1 The FSCS is the scheme for compensating persons, such as consumers, in cases where authorised financial services firms are unable, or likely to be unable, to satisfy claims and where the claimant meets the eligibility criteria specified in legislation. It is governed by rules made by the FCA and the PRA.

20.2 The FSCS is administered by the 'scheme manager', a body corporate established under section 212 of FSMA. In accordance with rules made by the FCA and PRA, the FSCS manager assesses and pays compensation to eligible claimants in respect of certain types of claims and has the power to impose levies on financial services firms to meet its expenses. The FSCS manager also pursues recoveries against firms, has a lending facility with commercial banks, and, as a last resort, can request a loan from HM Treasury.

20.3 The Office for National Statistics ('ONS') is responsible for compiling the National Accounts – core accounts for the UK economy as a whole that are designed provide a simple and understandable description of production, income, consumption, accumulation and wealth across different parts of the economy. In order to provide accurate National Accounts, the ONS classifies the entities making up the UK's economy by reference to certain sectors and subsectors.

20.4 In 2012, the ONS classified the FSCS manager as part of 'central government' because it considered the levies raised by the FSCS manager to be akin to taxation and therefore public money. It also took into account the fact that HM Treasury could act as a lender of last resort by granting a loan to the FSCS manager. As a result, the FSCS manager was considered an 'arm's length body' ('ALB') of HM Treasury, and its accounts were consolidated into HM Treasury Group accounts.

20.5 The ONS's 2012 classification resulted in, among other things, the following amendments to FSMA made by the Financial Services (Banking Reform) Act 2013:

a. Section 212(3)(aa) was amended so as to require the chief executive of the FSCS manager to be its accounting officer responsible to parliament.

b. Section 218B was inserted to enable HM Treasury to require information from the FSCS manager in connection with its duties under the Government Resources and Accounts Act 2000 relating to consolidating accounts.

20.6 In 2020, the ONS reviewed its classification, concluding that the scheme manager was a 'supervisory authority' and reclassified it as part of the 'public financial auxiliaries' subsector within the broader 'public financial corporations' sector. This decision was based on its view that the FSCS manager carries out supervisory actions regarding paying compensation and is able to freely take decisions to ensure it has sufficient resources. Reclassification has resulted in an incompatibility between the FSCS manager's status and the two parts of FSMA listed above.

**Rationale for intervention**

20.7 The ONS's reclassification does not fundamentally alter the constitution of the FSCS manager: it remains operationally independent of government. However, the decision means that the FSCS manager is no longer regarded as an ALB of HM Treasury. Therefore, its accounts will no longer be consolidated within HM Treasury's accounts.

20.8 The nature of the FSCS manager's accountability to HM Treasury and parliament, should change to reflect its reclassification and bring it into line with the treatment of other entities classified in the same way by ONS. In particular:

a. Retaining the accounting officer requirement for the FSCS manager would no longer be appropriate given the level of independence of bodies classified as public financial auxiliaries. HM Treasury does not appoint accounting officers for the FCA and PRA.

b. As the FSCS manager's accounts will no longer be consolidated within HM Treasury's accounts, there is no need for HM Treasury to have a power to require relevant information from the scheme manager for that purpose.

**Policy Objective**

20.9 The policy objectives are to ensure that, following reclassification:

a. the scheme manager's new status is properly reflected in the legislative framework;

b. the relationship between government and the FSCS manager reflects the intent of the ONS' decision and, therefore, so far as it is appropriate, is broadly consistent to that of HM Treasury's relationships with the PRA and the FCA; and;

c. key HM Treasury and parliamentary interests are protected, especially with regard to the FSCS manager's ability to be responsible for public money.

**Description of Options Considered**

20.10 Option 0 (Do nothing) - Given the FSCS manager's new status, it would be inappropriate for it to continue to have an accounting officer and therefore a direct line of accountability to Parliament. Since FSCS's accounts will no longer be consolidated within HM Treasury's accounts following its change in status, it would be unnecessary to retain the information sharing requirement.

20.11 Option 1 (Preferred Option) - Remove from FSMA the requirement for the FSCS manager's chief executive to be an accounting officer, and HM Treasury's power to require certain information from the FSCS manager relating to accounts.

**Outline of preferred policy**

20.12 This Bill will:

a. Amend section 212(3)(aa) of FSMA, removing the requirement that the FSCS manager's chief executive is an accounting officer; and

b. Remove section 218B of FSMA, thereby removing HM Treasury's power to require certain information from the FSCS manager in connection with accounts.

**Methodology**

20.13 The two changes relate specifically to the FSCS manager's governance structure and its relationships with Parliament and HM Treasury. Moreover, both changes are discrete in nature. This measure will have no EANDCB impact.

**Policy Costs**

20.14 As this measure only has an impact on public sector bodies (as although the scheme manager has been reclassified, it remains a public sector body), there are no EANDCB costs.

**Policy Benefits**

20.15 This measure has the benefit of removing unnecessary legislation from the statute book.

**Assumptions, limitations and considerations**

20.16 N/A

**Small and MicroBusiness Assessment (SaMBA)**

Number and distribution of businesses in scope of the regulation. Do the impacts fall disproportionately on small and microbusinesses?

20.17 This measure makes minor and technical amendments to the Financial Services and Markets Act 2000 (FSMA) to ensure the legal framework properly reflects the FSCS's new status following its reclassification by the Office for National Statistics (ONS) in 2020. Its effects are limited exclusively to FSCS governance and the FSCS's relationships with HMT and Parliament. This measure will have no impact on any of the FSCS's functions relevant to the financial services firms which pay FSCS levies, including payment of compensation and raising funds to meet costs. Therefore, there are no businesses including SMBs in scope of the changes this measure will introduce, and that there are no disproportionate impacts to consider for SMBs.

20.18 There are no impacts on any businesses including SMBs.

Could small and microbusinesses be exempted while achieving the policy objectives? Could the impact on small and microbusinesses be mitigated while achieving the policy objectives?

20.19 SMBs are not in scope of this legislation, and so do not need to be considered for exemptions or additional mitigations.

Wider impacts on small and microbusinesses

20.20 There are no wider impacts on SMBs.

## Reinsurance for Acts of Terrorism

**Problem under consideration**

21.1 In some instances, HM Treasury intervenes in the (re)insurance market to support the provision of insurance for certain systemic risks. This is when the risks would not otherwise be covered by the market because the potential financial losses are deemed too great by commercial (re)insurers. In cases of terrorism, HM Treasury has agreements with reinsurers under which it offers an unlimited guarantee (in the form of an unlimited loan) should they exhaust their funds in the event of pay-outs pursuant to a terrorist attack.

21.2 Under the Reinsurance (Acts of Terrorism) Act 1993 ("the 1993 Act"), HM Treasury has Parliamentary approval to pay out funds in line with these agreements. This enables the widespread provision of terrorism insurance in Great Britain. The 1993 Act was introduced when, following a number of terrorist attacks in Great Britain, (re)insurers withdrew from the terrorism (re)insurance markets. The 1993 Act enables the government to act as the reinsurer of last resort for reinsurance companies offering terrorism cover.

21.3 In accordance with its current practice, the Office for National Statistics ("ONS") is likely to classify a company that enjoys the benefit of a guarantee under the 1993 Act as a public sector body. Such classifications are likely to be retrospective to the date the company started to enjoy the benefit of a guarantee under the 1993 Act.

21.4 The consequences of a company being classified as a public sector body include a requirement that its accounts are consolidated into its sponsor department's departmental accounts (as required by the Government Resources and Accounts Act 2000) and it becomes subject to necessary and appropriate controls, standards and processes expected of a public sector (which may include central government) body, in line with government policy and the expectations of Parliament on the use of funds on the public account. This could include, for example, Managing Public Money ("MPM") guidance.

21.5 In order to secure compliance with the requirements associated with the classification as a public sector body, sponsor government departments generally put in place Framework Documents with entities subject to this classification. However, Framework Documents are not legally enforceable.

**Rationale for Intervention**

21.6 HM Treasury needs to ensure that any entity classified as a public body which benefits from an arrangement under the 1993 Act, will comply with the necessary controls so that money on the public accounts is managed appropriately.

**Policy Objective**

21.7 The objective of this provision in the Bill is to ensure that any public sector body that benefits from an arrangement under the 1993 Act can be obliged to comply with any requirements associated with their public sector classification and/or to appoint an Accounting Officer. The requirements may include matters relating to:

a. Auditing - for example, MPM which sets out the main principles for the management of resources in UK public sector organisations.

b. Accounting - for example, Government Financial Reporting Manual (FReM) standards, which are the public sector accounting standards.

c. Budgeting - for example, MPM and the Consolidated Budgeting Guidance, which is the budgeting framework that applies for expenditure control.

d. Arm's length bodies – for example, MPM as per above.

e. Public sector bodies - for example, MPM as per above and public sector pay guidance.

**Description of Options Considered**

21.8 Option 0 (Do nothing) – Taking no action would mean there is a gap in HM Treasury's ability to ensure that any entity classified as a public body that benefits from an arrangement under the 1993 Act complies with public sector governance requirements.

21.9 Option 1 (Preferred Option) - Amend the 1993 Act to ensure that any entity classified as a public body that benefits from an arrangement under the 1993 Act can be obliged to comply with necessary controls so that money on the public accounts is managed appropriately.

**Outline of preferred policy**

21.10 This provision in the Bill will amend the 1993 Act to give HM Treasury the power to issue directions to any public sector body which benefits from an arrangement under the 1993 Act.

21.11 The provision also provides HM Treasury with the ability to issue a direction to the group undertakings (within the meaning of s.1161 of the Companies Act 2006) of public sector bodies which benefit from an arrangement under the 1993 Act. HM Treasury may issue a direction if it considers it necessary for the purpose of ensuring compliance with any requirements associated with classification as a public sector body. Directions may include provision about compliance with relevant requirements relating to auditing, accounting, budgeting, arm's length bodies or public sector bodies.

21.12 There is also a specific power to direct such bodies to appoint an Accounting Officer. This will enable HM Treasury to ensure that any public sector body that benefits from a guarantee has sufficient oversight of its requirements as a public sector body.

21.13 There are a number of safeguards built into this provision to ensure that any exercise of the power by HM Treasury is properly justified. These include the requirement that a direction can only be issued to a narrow category of entities (as set out above) and that HM Treasury must consult with such entities before giving them a direction. Any direction must also be accompanied by a written notice which states when the direction takes effect and gives reasons for the direction, and the direction must also be published by HM Treasury and laid before Parliament.

21.14 The provision enables HM Treasury to bring proceedings to enforce compliance with a direction by seeking an injunction, or, in Scotland, an order for specific performance under section 45 of the Court of Session Act 1988.

**Methodology**

21.15 This measure provides a necessary safeguard power for the government to ensure compliance with the requirements expected of a public sector body, in line with government policy and the expectations of Parliament on the use of funds on the public account. As such, this measure is not expected to result in additional costs for affected entities above and beyond those costs which will already be incurred to comply with the necessary controls. There are therefore no EANDCB costs associated with this measure.

Population within scope of this proposal

21.16 HM Treasury currently has agreements under the 1993 Act in place with two reinsurers (Pool Reinsurance Company Limited and Pool Reinsurance (Nuclear) Limited) under which it offers a guarantee (in the form of an unlimited loan) should they exhaust their funds in the event of pay-outs pursuant to a terrorist attack. At present, only Pool Reinsurance Company Limited is classified to the public sector, specifically the central government sub-sector, and so falls within scope of the provision. In accordance with its current practice, ONS is likely to classify Pool Reinsurance (Nuclear) Limited as a public sector body at which point it will also fall within scope of the provision. Also, future arrangements may be made with reinsurers who are or subsequently become similarly classified with the effect that other entities will also fall within scope of this provision.

**Policy Costs**

21.17 As set out above, this measure is not expected to result in additional costs for affected entities above and beyond those costs which will already be incurred to comply with the requirements expected of a public sector body, in line with government policy and the expectations of Parliament on the use of funds on the public account.

**Policy Benefits**

21.18 This measure provides a necessary safeguard power for the government to ensure compliance with the requirements expected of a public sector body, in line with government policy and the expectations of Parliament on the use of funds on the public account. Ensuring these requirements are met will in turn provide value for money, probity, regularity and propriety in the public sector bodies within scope of this provision.

**Assumptions, limitations and considerations**

21.19 As set out above, this measure is not expected to result in additional costs for affected entities above and beyond those costs which will already be incurred to comply with the requirements expected of a public sector body, in line with

government policy and the expectations of Parliament on the use of funds on the public account.

**Small and MicroBusiness Assessment (SaMBA)**

Number and distribution of businesses in scope of the regulation. Do the impacts fall disproportionately on small and microbusinesses?

21.20 This measure provides HM Treasury with a necessary safeguard power to ensure compliance with the requirements expected of a public sector body, in line with government policy and the expectations of Parliament on the use of funds on the public account. The measure does not of itself change the nature of those requirements and there are no wider impacts associated with this measure. There is currently one public sector body which falls in scope of the power.

21.21 Therefore, HM Treasury considers that there are no disproportionate costs to SMBs as a result of this measure.

Could small and microbusinesses be exempted while achieving the policy objectives? Could the impact on small and microbusinesses be mitigated while achieving the policy objectives?

21.22 SMBs are not in scope of this legislation, and so do not need to be considered for exemptions or additional mitigations.

Wider impacts on small and microbusinesses:

21.23 There are no wider impacts on small or microbusinesses associated with this measure.

## Banking Act 2009: Miscellaneous Amendments

**Problem under consideration**

22.1 There are four minor drafting issues in the Banking Act 2009 (the "Banking Act"). Two of these issues were introduced into the Banking Act by amendments made in 2018 and 2020, two when the Act was introduced. A fifth amendment is also necessary to maintain a status quo following the introduction of this Bill.

22.2 The first issue arises in section 7A(1) of the Banking Act where there are incorrect cross references to provisions that no longer exist. This unintentionally removes obligations that the Bank of England (Bank) must adhere to before directing firms to issue eligible liabilities – equity and debt that can be used to absorb losses when a financial institution fails, with the aim of reducing the risk to public funds. There is also an associated lack of clarity as to whether such obligations apply to the Bank when directing firms to alter the maturity of eligible liabilities.

22.3 The second is in section 89(H) of the Banking Act, where text with no practical effect reduces the clarity of the provision in relation to a requirement for the Bank to make recognition decisions regarding third country resolution actions.

22.4 The third is in section 83ZD where there is an incorrect cross reference. The section establishes the Bank's power to appoint an investigator in certain circumstances and seeks to ensure this power to investigate does not apply to regulatory sanctions imposed by Section 83ZR. However, despite referencing the title of section 83ZR ("Regulatory sanctions") it mistakenly cross refers to section 83ZN (entitled "Offences etc") instead of 83ZR.

22.5 The fourth regards a lack of clarity over whether government can apply a recognition of a payment system as systemic, under section 182, prior to the system commencing operation within the UK.

22.6 Finally, section 244 of the Banking Act provides that the Bank, its directors, officers, employees and agents are immune from liability in damages for anything done or not done in the exercise of its functions, as described in that section. A fifth amendment clarifies that this immunity will extend to new functions conferred by or under this Bill.

**Rationale for intervention**

22.7 The issues in section 7A(1) and 182 introduce uncertainty to a process that is established by the Banking Act, and runs contrary to the original policy intent of the legislation.

22.8 If changes are not made to section 89H(7) of the Banking Act, there are meaningless words in statute which could reduce the clarity of the legislation.

22.9 If the changes are not made to section 83ZD, the clause will continue to lack clarity and the original policy intent of the legislation may be undermined.

22.10 The change to section 244 maintains the established principle of Bank immunity while acting in its capacity as a monetary authority.

**Policy objective**

22.11 The objective is to provide greater legislative clarity and ensure that the law works as intended.

**Description of options considered**

22.12 Option 0 (Do nothing) - without changes to legislation the lack of clarity will persist, which will continue to introduce uncertainty around these provisions of the Banking Act.

22.13 Option 1 (Preferred Option) - make necessary technical amendments in the Banking Act.

**Outline of preferred policy**

22.14 The Bill amends sections 7A(1), 83ZD, 182 and 244 of the Banking Act 2009 to clarify and include references to the correct provisions. It also deletes the unnecessary and potentially confusing language in section 89H(7) of the Banking Act 2009.

**Policy Costs**

22.15 There are no EANDCB costs associated with these amendments.

**Policy Benefits**

22.16 There will be improved legislative clarity in relation to these provisions in the Banking Act.

**Small and MicroBusiness Assessment (SaMBA)**

Number and distribution of businesses in scope of the regulation. Do the impacts fall disproportionately on small and microbusinesses?

22.17 The provisions within these clauses are minor technical amendments to correct and clarify a small number of drafting issues in the Banking Act 2009. None of the provisions represent a change in the way legislation applies to individual businesses, rather ensuring absolute clarity in existing provisions, and as such this measure does not impact on businesses of any size, including small or microbusinesses.

22.18 Therefore, it does not disproportionately affect SMBs.

Could small and microbusinesses be exempted while achieving the policy objectives? Could the impact on small and microbusinesses be mitigated while achieving the policy objectives?

22.19 No. Such an exemption could potentially disadvantage SMBs as it would mean the legislation as it applies to such businesses would be less clear than as it applies to larger businesses. As mentioned previously, there is no overall cost to businesses so there is no case to exempt or consider mitigations for SMBs. To the extent to which this measure has any impact, it will be positive as it will provide greater clarity in the legislation. There is no need for mitigations for any businesses

Wider impacts on small and microbusinesses

22.20 The measure as a whole consists of minor technical amendments. This will improve the clarity of legislation but as the overall impact is minimal there will not be wider impacts on SMBs.

## Control Over Authorised Persons

**Problem under consideration**

23.1 Where a person decides to acquire control of a UK authorised financial services firm (defined as acquiring a stake of 10% or more in the firm), the proposed buyer is required by section 178 of FSMA to apply to the relevant regulator before the interest is acquired. The application needs to be sent to the FCA where it relates to firms authorised by the FCA, or to the FCA and the PRA for dual-authorised firms (firms authorised by both the PRA and the FCA).

23.2 The application must include:

a. Completed Section 178 notification forms for every individual or entity proposing to take control.

b. A regulatory business plan.

c. Financial projections.

d. An organogram showing before and after positions.

23.3 The regulators (the PRA and/or FCA as appropriate) will make a decision about whether to approve or reject the change in control, based on:

a. The reputation of the Section 178 notice-giver;

b. The reputation and experience of any person who will direct the business of the UK regulated entity;

c. The overall financial position of the Section 178 notice-giver;

d. Whether the UK financial services firm will be able to comply with its prudential requirements including the threshold conditions (the minimum requirements for the financial services firm to be authorised and stay authorised) in relation to its regulated activities) following the change;

e. Whether the new business structure will be able to exercise effective supervision and exchange information with the relevant regulator; and

f. Whether there are reasonable grounds to suspect that the new controller is connected with money laundering or terrorist financing or that the risk of this activity could increase.[372]

23.4 The PRA and FCA can only reject an application for a change in control where there are "reasonable grounds" for doing so. The PRA and FCA may approve a change in control but impose conditions on it, but FSMA specifies that they may only impose conditions where, without those conditions, they would otherwise reject the application.

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[372] As defined in the: Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017

23.5 However, there are some situations where the evidence may not reach the legal threshold of having reasonable grounds to reject an application, but there are concerns about the application. A particular example of this is where investigations relating to the notice-giver are ongoing while the change-in-control process is taking place, and where the investigation could conclude that the notice-giver is not fit.

**Rationale for intervention**

23.6 FSMA requires that the PRA and FCA need to have “reasonable grounds” to block a change or impose conditions. The government believes that there are circumstances where it may be appropriate to give the regulators greater ability to impose conditions on new controllers. An example of this could be if a new controller is subject to an investigation, which *could* lead to a prosecution which would make them ineligible to be a “controller”. While they would be unable to prevent them becoming a controller (insufficient evidence and/or the individual could be innocent), enabling conditions to be imposed in a wider set of circumstances will assist the regulators in limiting the potential negative impacts of these controllers.

23.7 This change can only be given effect by amending the relevant parts of FSMA which set out the grounds on which the FCA and PRA can impose conditions on a change of control.

**Policy objective**

23.8 The objective is to ensure that the FCA and PRA can reduce the risk of new controllers where the regulators have doubts about their fitness, but where the evidential threshold to reject the application, as set in FSMA, is not met.

**Description of options considered**

23.9 Option 0 (Do nothing) - without a change in legislation, the regulators would be unable to restrict the influence of individuals who they have concerns about but which do not meet the evidential threshold, for example those who are currently under investigation.

23.10 Option 1 (Preferred Option) - amend FSMA to enable conditions to be applied in a wider range of scenarios.

**Outline of preferred policy**

23.11 The Bill will remove the current restriction in FSMA which only allows the regulators to impose conditions on a change in control where they would otherwise reject the application. This will allow the regulators to apply conditions on new controllers where necessary. The conditions which the regulators can apply will remain the same as they currently are, and focus on reducing the new controller’s influence of the running of the company (e.g. they cannot take up a Board position, exercise their voting rights, influence decisions, etc.).

23.12 This change will be made through a small amendment to the existing circumstances for applying conditions to a new controller, set out in Part XII FSMA.

**Methodology**

23.13 These changes have been compared to the 'Do Nothing' scenario above.

Population within scope of this proposal

23.14 This measure will only affect potential "controllers" of firms and not directly impact UK firms themselves. Last year, the FCA (jointly with the PRA where appropriate) received 1,745 notices for a change in control.

23.15 Of these, the vast majority are approved, with a small number of objections. Without re-evaluating all past decisions, it is not possible to accurately identify a potential number of cases this could impact. However, given the vast majority of cases are approved without issue, and these conditions would only be deployed in tricky middle cases between clear objections and clear approvals, which are rare, HM Treasury considers that– a central assumption of conditions being applied in 1-2% of cases (17 – 34) is a reasonable range.

23.16 There is no change to the information that a proposed controller needs to provide to the regulators when making an application.

**Policy Costs**

Costs to the public sector

23.17 There are no additional costs expected to the regulators. This policy gives the regulators an extra tool with which to approach an application. However the process that the regulators need to go through to assess an application is unchanged.

Costs to firms

23.18 There are no direct costs on the firms themselves that the applicant is looking to take control of.

23.19 The only potential cost is the opportunity cost of the impact a controller could have had on the direction of the business, but which the conditions specified by the regulators limit them from doing. This is unquantifiable.

**Policy Benefits**

23.20 There will be a reduced risk of new controllers creating potential risks to the firms themselves, as the regulator has more options for limiting influence.

**Small and MicroBusiness Assessment (SaMBA)**

Number and distribution of businesses in scope of the regulation.

23.21 As noted above, HM Treasury considers it likely that the regulators will only look to apply conditions to a small proportion of change in control applications: 1 to 2%, which equates to approximately c17 to 34 cases p.a. Unfortunately, no data is captured on either the number of new controllers who are 1) individuals, 2) the same business, just a different entity (e.g. were a subsidiary – which is its own separate legal entity – subsumed into another entity in the group) or 2) businesses

(which could include SMBs). It has therefore not been possible to estimate how many SMBs submit change in control applications.

Do the impacts fall disproportionately on small and microbusinesses?

23.22 This measure does not directly impact on the SMBs that an applicant is looking to take control of.

23.23 The only potential indirect cost is the opportunity cost of the impact a controller could have had on the direction of an SMB, but which the conditions specified by the regulators limit them from doing. This is unquantifiable.

23.24 However, SMBs should benefit from the reduced risk of new controllers creating potential risks to the firms themselves, as the regulator will have more options for limiting influence.

Could small and microbusinesses be exempted while achieving the policy objectives? Could the impact on small and microbusinesses be mitigated while achieving the policy objectives?

23.25 HM Treasury considers the change in control measure to be proportionate and necessary to apply to small and micro businesses, and so does not consider an exemption to be appropriate, nor is there a need (or ability) to mitigate the impacts in a way that still achieves the policy objective. If the regulators have significant concerns about a change in control they should be able to attach conditions, regardless of the size of the business.

23.26 Carving small and micro businesses out of this change would fundamentally undermine the policy intent of the measure – to ensure new controllers are of sufficient repute to run a financial services firm and be responsible for the firm and their customers funds.

23.27 Furthermore, this change does not prevent new controllers taking control, it just offers the regulators a lever to limit their influence on the firm if they have concerns.

Wider impacts on small and microbusinesses

23.28 There are no wider impacts on small or microbusinesses associated with this measure.

## Wider Impacts

24.1 There are a number of wider impacts of the measures contained in this Bill which cannot be quantified at this stage, and include equalities impacts, competition impacts, trade and investment implications, innovation impacts, consumer impacts, impacts on financial stability and environmental impacts.

24.2 At the point of secondary legislation, and in line with the government's approach to better regulation under the Better Regulation Framework, HM Treasury will make efforts where appropriate to further consult on and understand any potential wider impacts, including through appropriate stakeholder engagement. More detailed qualitative and quantitative cost-benefit analyses are expected to be covered in the IAs accompanying the relevant secondary legislation enabled by the Bill. HM Treasury will also engage with the RPC, prior to the submission of IAs produced to accompany future secondary legislation where appropriate.

24.3 Where the final wider impacts of a measure are dependent on the outcome of policy decisions which sit within the remit of the independent financial services regulators, HM Treasury is content that in such cases, the regulators will have in place appropriate mechanisms to consider the impact of such decisions, including as required by the Bill.

24.4 More information on the FCA and PRA's approach to assessing costs and benefits, including how that will be bolstered by measures in this Bill can be found in the section *FRF Review: Accountability and Stakeholder Engagement*.

**Equalities Impacts**

24.5 The Public Sector Equality Duty (PSED) under the Equality Act (2010) requires public authorities and others to carry out public functions to have due regard to:

a. Eliminating unlawful discrimination, harassment, victimisation and any other conduct prohibited by the Equality Act 2010.

b. Advancing equality of opportunity between people who share a protected characteristic and people who do not share it.

c. Fostering good relations between people who share a protected characteristic and those who do not.

24.6 The FSM Bill contains over 20 measures which have been considered for potential equalities impacts. There are five measures in the Bill where equalities and impacts on families have been identified, all of which are considered to be positive, either directly or indirectly as a result of this legislation. These are summarised below.

*24.7* Any further equalities impacts will be reviewed ahead of the final stage impact assessments for secondary legislation where appropriate.

Cash Access Services

24.8 Evidence suggests that cash use is associated with groups who share protected characteristics, such as age and disability. As a result, the government believes that this policy, which aids financial inclusion, is likely to support equality of opportunity between people who share such protected characteristics and people who do not.

Wholesale Cash Distribution

24.9 This measure will help ensure a sustainable wholesale cash network, of which the immediate beneficiaries will be the public as a whole, and specifically frequent cash users and those dependent on cash as a means of payment. The FCA's Financial Lives Survey found that 5.4 million adults, particularly those in vulnerable groups were reliant on cash as of February 2020. This measure supports financial inclusion, particularly for older groups and those with a disability, so they are enabled to participate in society and the wider economy. In addition, cash is a back-up form of payment in the event of wider disruption to other payment methods, and so a resilient supply of cash is important to confidence in the UK's financial system and financial stability, from which all of society benefits.

Amendments to Credit Union Legislation

24.10 This measure is expected to have a direct positive impact relating to families going through a negative life event. Allowing credit unions to expand their product offering will widen access to affordable credit and financial services, which may help those who are experiencing a negative life event. For example, this measure will enable credit unions in Great Britain to offer insurance distribution services to their members, which, depending on the credit union's individual operating decisions, may include insurance offerings related to life insurance and critical illness cover. This measure is also expected to have a direct positive impact relating to families going through a positive transition, such as becoming parents, getting married, fostering, or adopting.

Insurers in financial difficulties

24.11 Certain protected groups (primarily the elderly and disabled people) are more likely to derive significant income from insurance products compared to the general population. This means these groups are more likely to be impacted by the use of the amended procedures. However, these measures will provide positive benefits to these groups versus existing protections in the event of insurer failure, chiefly through the enhanced policyholder protections – primarily continuity of cover – made available.

Regulatory Gateway for Approving Financial Promotions

24.12 The gateway measure is expected to have a positive impact on individuals by making it more likely they will receive higher-quality financial promotions. The measure will not deliver a different outcome for any particular group, as where promotions are improved, the benefit will be the same for all investors. However, the FCA's Financial Lives Survey 2020 suggests that those who hold investments are more likely to be male, older and white than the population as a whole, suggesting that the aggregate

benefits will be weighted towards these groups. It is not possible to determine a precise link between financial vulnerability and likelihood of holding investment products. Those who are financially vulnerable are typically less likely to hold investment products, but when they do, they may be particularly vulnerable to inappropriate financial promotions. The FCA's Financial Lives Survey 2020 suggests that 51% of females show one or more characteristic of financial vulnerability, compared to 40% of males; and 63% of black and black British ethnicity show one or more characteristic of vulnerability compared to 45% of white ethnicity.

**Competition and competitiveness of the UK**

24.13 The following measures in this Bill will impact competition across the UK economy.

Financial Market Infrastructure – Regulatory Sandboxes

24.14 This measure will enable the testing of new technology or practices in financial markets, leading to potential substantial benefits for participating firms, including increased efficiency and innovation.

24.15 In the long term, it is possible that existing FMIs could face increased competition from firms in the FMI Sandbox, which could be disruptive to the market as a whole. One potential solution could be facilitating interoperability between new entrants and existing incumbents, or between new entrants. If firms participating in the Sandbox are successful, then it is possible that existing FMI incumbents could be displaced altogether. Competition is a key driver of the sandbox, and innovation is seen as a way to improve the market as a whole. However, many FMIs are highly systemically important, and it is crucial that any such transition is managed carefully by both Government and regulators.

Amendments to Credit Union Legislation

24.16 The proposed amendments to Credit Union legislation will allow credit unions to offer a wider range of products and services to enhance their role in the financial inclusion agenda and expand access to affordable credit.

24.17 This may have competition impacts on the insurance broking sector. There are more than 1,800 insurance broking firms who are members of the British Insurance Broker's Association (BIBA). There are also likely to be several additional insurance intermediary firms. The size of the existing broking sector, relative to the number of credit unions projected to offer insurance intermediation services (118) means that any impact on the insurance brokerage market is likely to be negligible and may serve to mitigate disruption in the insurance brokerage market. Credit unions, as not-for-profit cooperatives with unique customer bases, may help provide improved access to insurance intermediation services to some consumers not traditionally as well served by the broking market, such as consumers that struggle to access affordable financial products. More generally, greater competition in the market is expected to support improved outcomes for consumers in terms of better and lower-cost services. Due to limited data on how this legislation might impact the sector, this analysis does not attempt to calculate this impact.

24.18 One wider, indirect impact on business is that as credit unions distribute insurance products provided by an insurance firm, these insurance firms may sell insurance to a greater number of people, thus increasing their income and providing greater competition.

Implementation of Mutual Recognition Agreements and Amendments to the EU Securitisation Regulation 2017

24.19 By taking a power to be able to implement mutual recognition agreements and allowing HM Treasury to recognise overseas STS securitisations as equivalent to those in the UK, the Bill strengthens the UK's position as an open and global financial hub.

24.20 Recognising overseas STS securitisations could lead to greater competition for investment between STS securitisations issued by UK firms and STS securitisations issued in recognised equivalent jurisdictions. It could also lead to overseas recognition of UK STS securitisations, which would provide UK securitisation issuers with greater demand and greater liquidity for their STS securitisations.

24.21 The MRA implementation provisions reduce the time it will take to implement MRAs. Having MRA's in place is likely to confer benefits on the UK financial services industry through lower costs and ease of access for businesses undertaking financial services activities overseas, and the subsequent economic benefits associated with this, including greater trade and profits for businesses and lower costs for consumers. This should lead to greater competition for UK firms and increased innovation as UK businesses respond to overseas firms.

Regulatory Gateway for Approving Financial Promotions

24.22 The new regulatory gateway will give the FCA greater oversight of the market for financial promotions approval and the number of participants having their financial promotions approved. There will be a potential impact on competition in the market as fewer firms will be able to approve the promotions of other firms. There is a risk that the cost for approving financial promotions increase as there will be fewer approver firms in the market following the introduction of the gateway.

24.23 As also noted in the Small and Microbusiness Assessment, the FCA will closely monitor the marketplace for approving financial promotions and consider acting where necessary. In particular, the FCA are considering changes in the future which may see them collecting data from firms on revenue earned from financial promotion approval activity in order to help them identify any impacts on competition. The FCA have also extended existing 'conflicts of interest' obligations to firms approving financial promotions for unauthorised persons in their August 2022 Policy Statement, in order to prevent firms from using their position as a gateway approver to gain a competitive advantage over their competitors.

FRF Review – Repeal of Retained EU Law

24.24 Following the repeal of retained EU law, the move to a comprehensive FSMA model of financial services regulation where the regulators make detailed firm-facing requirements should lead to more proportionate regulation both for UK financial services firms, and for non-financial services firms wishing to engage with financial markets. Regulation more suited to the challenges and opportunities facing UK firms and a reduced regulatory burden should promote growth and market access leading to increased competition within the UK financial sector and beyond. As the financial services sector has a wider role in supporting UK businesses across a number of different sectors, it is expected that a more agile and dynamic regulatory regime will create positive outcomes in the wider economy – for example, by improving the financial services sector's ability and capacity to provide funding to UK businesses.

FRF Review – Objectives and Principles

24.25 The long-term growth and competitiveness objectives for the PRA and the FCA will require and provide an appropriate statutory basis for the regulators to discharge their functions in a way that advances the UK's growth and international competitiveness. The financial services sector is at heart of the UK's economy. More effective and proportionate regulation for the sector will therefore also have spill-over effects for firms in the wider economy. As a result of rules made with these considerations in place, the financial services industry will be better able to direct investment, to provide personal finance, and to support the wider economy in general.

FRF Review – Deference and Trade Accountability Mechanisms

24.26 This measure enables information sharing between the regulators and HM Treasury with regards to the government's deference arrangements and the UK's trade agreements. Both mechanisms will help the government implement its strategy to support cross border financial services with the intention that this will generally promote the international competitiveness of the sector which may benefit firms conducting cross border activities.

FRF Review – Accountability and Stakeholder Engagement

24.27 More effective stakeholder engagement, Parliamentary scrutiny, and transparency about the processes (including for CBA and rule review) are intended to lead to more effective regulation in financial services. This should mean that the regulators make regulatory requirements and decisions with appropriate consideration given to the challenges and opportunities facing UK firms, leading to regulation conducive to increasing the competitiveness of the UK financial services sector.

**Trade and Investment**

24.28 The Bill will improve trade and investment both across the UK, and internationally through the following measures:

Cash Access Services

24.29 This measure introduces a responsibility and powers for the FCA to seek to ensure the reasonable provision of cash access. This measure facilitates trade by supporting the continued use and acceptance of cash.

Wholesale Cash Distribution

24.30 Wholesale Cash Distribution will create a statutory oversight regime that will provide the Bank of England (Bank) with the powers to oversee the wholesale cash industry. This is so they can manage the risks posed by uncoordinated rationalisation and/or consolidation, and the risks to financial stability posed by a severe disruption in the network. This will ensure that wholesale cash supply remains effective, resilient, and sustainable as the use of cash for transactions declines. This measure facilitates trade by supporting the continued use and acceptance of cash.

Amendments to Credit Unions Legislation

24.31 This measure will allow credit unions to offer a wider range of products beyond loans. The ability of CUs to offer HP/CS agreements could mean that incumbent retail banks and Motor Finance firms see a slight decrease in lending. However, given the size of the existing car finance and lease market, any impact on current lenders would be negligible.

24.32 The Finance and Leasing Association (FLA) is the leading trade association for the motor finance sector in the UK and covers the vast majority of the car finance and lease sector. In 2021, FLA's members provided £45 billion of new finance to help households and businesses purchase cars[373], and 92% of all private new car registrations in the UK were financed by FLA members. The size of the existing car finance and lease sector, relative to the number of credit unions projected to offer car finance services in the form of HP/CS (168), may serve to mitigate disruption in the car finance and lease sector.

Wholesale Markets Review

24.33 The measure aims to ensure that the regulatory regime for wholesale markets is fair, outcomes-based and supports competitiveness, whilst ensuring the UK maintains the highest regulatory standards.

24.34 The UK's capital markets are some of the deepest and most liquid globally. The changes brought about through this measure will reinforce that while maintaining the highest regulatory standards. These changes will improve efficiency in UK capital markets and will lead to improved investor confidence through the enhanced functioning of capital markets in the UK. This will ensure that the UK continues to be an attractive place for investment and to raise capital. A well-functioning and robust wholesale markets regime will benefit all market participants, including businesses in the economy that need to raise capital to fund growth, by stimulating investment.

[373] https://www.fla.org.uk/motor-finance/

24.35 The government also anticipate that there will be wider benefits to market participants in the UK who are clients of, or trade with, investment firms or trade on trading venues or SIs or use the services of data reporting service providers directly impacted by this measure. This should result in those directly impacted by these changes passing on cost savings from the reduced cost of compliance with overly prescriptive rules. These cost savings are expected to trickle down to those not directly affected by this measure.

FRF Review – Deference and Trade Accountability Mechanisms

24.36 The intention of the deference mechanism is to improve the quality of information available to the regulators when exercising their regulatory powers, and therefore support HM Treasury's management of deference arrangements. The trade mechanism is designed to ensure that the regulators consider the impact of their decision making on trade agreements and share information on their considerations with HM Treasury. This will ensure HM Treasury can take appropriate action if the decision making of the regulators is likely to lead the UK to being in breach of its trade agreements. This will have a wider impact on trade by improving the UK's status and reliability as a trading partner and by providing a stronger framework to protect future trade.

**Innovation**

24.37 The government's vision for financial services is to promote innovation and the adoption of cutting-edge technologies. The Bill delivers on this through a number of key measures.

Financial Market Infrastructure – Regulatory Sandboxes

24.38 The Bill will enable firms to experiment and test new technologies and practices such as Distributed Ledger Technology (DLT) (a form of database technology that digitally records transactions across multiple ledgers at the same time) within regulatory sandboxes. The use of an FMI Sandbox will ensure that new technology is trialled in a controlled and safe environment and the outcomes are fully assessed. This will inform how Government and regulators should proceed in terms of legislative and regulatory reforms, which safeguard the benefits of the current system while also ensuring that the potential wider benefits to innovation are captured.

Digital Settlement Assets

24.39 This measure allows HM Treasury to bring digital settlement assets, which are forms of digital assets used for payments, within the UK payments regulatory perimeter. The government intends to use the powers in the Bill to, initially, provide for the regulation of stablecoins backed by fiat currency, which are a type of digital settlement assets. The changes will ensure that consumers can use digital settlement asset services including stablecoins with confidence. For firms, this Bill will create the conditions for issuers and service providers to operate and grow in the UK. Regulation is likely to create an environment in which ongoing innovation can be continued or accelerated in the context of greater user trust.

FRF Review – Regulation of FMI by the Bank of England

24.40 This measure introduces broad rule-making powers for the Bank over central counterparties (CCPs) and central securities depositories (CSDs), along with an updated set of statutory objectives and accountability measures. This may have wider impacts as a result of any rules the Bank subsequently makes with its new powers under the new framework. In particular, the Bill introduces a secondary objective for the Bank to facilitate innovation in the provision of services by CCPs and CSDs. The government expects that this will encourage increased innovation, improving the quality, efficiency and economy in the delivery of these services.

FRF Review - Objectives and Principles

24.41 The long-term growth and competitiveness objectives for the PRA and the FCA will require and provide an appropriate statutory basis for the regulators to discharge their functions in a way that advances the UK's growth and international competitiveness.

24.42 Respondents to the governments' consultations also suggested that long-term growth and international competitiveness objectives will add to the existing institutional incentives for regulators to consider innovation in their rulemaking. This should lead to a regulatory environment in which both new and ongoing innovation can be accelerated.

**Consumer Impact**

24.43 Protecting UK consumers and safeguarding against potential impacts is within scope for every measure of the Bill, however a number of consumer specific areas have been targeted to ensure the Financial Services and Markets Bill advances the rights and protections of UK consumers.

Digital Settlement Assets

24.44 The enabling of the UK's regulators to set firm-facing requirements in a framework set by government will allow for the future regulation of cryptoassets and the safe adoption of stablecoins as a form of payment in the UK. This consumer led regulation prioritises the safety of consumers while empowering the UK to innovate.

Amendments to Credit Unions Legislation

24.45 This measure will allow credit unions to offer a wider range of products beyond loans. As a result of credit unions offering additional services, the increased competition in the car finance and insurance distribution markets, will lead to a greater choice for consumers.

24.46 Credit unions may compete with other providers of these services. Although this may reduce the income of those providers, this is outweighed by the likely benefits to UK consumers. Evidence from the FCA notes that consumers have benefited from the intensified competition in other markets such as the residential mortgage and SME lending markets through increased choice and lower prices.[374]

[374] Strategic Review of Retail Banking Business Models: Final Report 2022 (fca.org.uk)

24.47 Additionally, many credit unions may serve borrowers which are at higher risk of defaulting on their loans, and may not be able to borrow from mainstream banks or building societies. By expanding the types of products that credit unions can offer, it is possible that more consumers will use them rather than other types of lenders, such as illegal loan sharks. The most recent government analysis from 2010[375] estimated that around 310,000 borrowers in the UK could be using illegal lenders. In March 2022, the Centre for Social Justice estimated that there could be around 1.08 million borrowers in England using illegal loan sharks.[376] As loan sharks are illegal, it is difficult to estimate the true number of people that borrow from them leading to the wide range of estimates of the number of borrowers. We would therefore consider allowing credit unions to offer wider products and services as a benefit of this legislation which provides for wider diversity in Great Britain lending markets and would provide additional lower-cost products for consumers to consider.

Liability of payment services providers for fraudulent transactions

24.48 The measure clarifies that there is no legislative barrier preventing the Payment Systems Regulator (PSR) from taking regulatory action to mandate reimbursement for Authorised Push Payments scam victims by their payment service provider (e.g. bank) when the payment is made through any designated payment system.

24.49 HM Treasury considers that the wider benefits of the measure to consumers will be significant, as the psychological stress and other negative wellbeing factors associated with fraud is reduced through more consistent and comprehensive reimbursement. Consumers can face significant psychological costs associated with losing their savings to fraudsters, particularly in cases such as romance scams, and clearer and more consistent grounds for reimbursement by Payment Service Providers (PSP) should help mitigate these issues. Therefore, the government considers that increased APP fraud reimbursement and prevention as a result of this policy is likely to have material wider benefits for the individual consumers concerned. This psychological benefit is not possible to quantify, but given that some victims may lose life-changing sums (thousands of pounds), this is nonetheless an important benefit. As such, looking at reimbursement levels alone underestimates the benefit, as this ignores wellbeing benefits from prevented/avoided fraud as well as the financial hardship that this may bring to consumers in larger value cases (e.g. when entire savings are put in jeopardy).

24.50 Similarly hard to quantify, but also important, is the contribution that increased reimbursement would make to 'trust in the system', encouraging greater adoption and use of online payment systems, and contributing to the Government's broader goals of supporting financial inclusion. As noted in the Digital Payments Report by the PSR Panel into barriers to the take-up of digital payments, one such barrier is

[375] Report prepared by POLICIS for Department for Business,Innovation and Skills : Interim Evaluation of the National Illegal Money Lending Projects (publishing.service.gov.uk)

[376] https://www.centreforsocialjustice.org.uk/wp-content/uploads/2022/03/CSJ-Illegal-lending-paper.pdf

distrust of digital payments as a result of concerns about fraud or personal error.[377] Mandatory reimbursement for APP scam victims will help tackle this barrier, contributing to better consumer protections and therefore enhanced inclusivity in digital payments.

Cash Access Services and Wholesale Cash Distribution

24.51 Access to Cash will have significant positive consumer impacts. Evidence suggests that cash use is associated with certain groups who share protected characteristics, such as age and disability. As a result, the government believes that this policy, which aids financial inclusion of such groups, is likely to support equality of opportunity between people who share such protected characteristics and people who do not.

FRF Review – Repeal of retained EU law

24.52 Following the repeal of retained EU law, the move to a comprehensive FSMA model of financial services regulation where the regulators make detailed firm-facing requirements should lead to regulation more suited to the challenges and opportunities facing UK firms and consumers. This measure will ensure the regulators are able to make rules appropriate for the protection of consumers of UK financial services, in pursuit of their consumer protection objectives and unconstrained by EU set regulation.

FRF Review – Accountability and Stakeholder Engagement

24.53 More effective and agile financial services regulation will have a wider positive impact on consumers. By ensuring that consumer groups are better able to feed into regulator decision-making, the enhanced mechanisms will also contribute to better consumer protection in financial services. Consumer protection is also one of the FCA's objectives, and so the FCA will advance it more effectively with better CBA and more frequent review of rules.

Financial Conduct Authority (FCA)/Financial Ombudsman Service/Financial Services Compensation Scheme (FSCS) cooperation on wider implications issues

24.54 This measure will extend the FCA's and FOS' existing obligation to cooperate by specifying they must take co-operate on issues with wider implications. The measure provides for stakeholders, including small and microbusinesses, to provide representations to the authorities on the extent to which they are judged to be complying with the duty to cooperate on wider implications issues. This will provide a wider benefit to stakeholders by providing a mechanism for their views to be shared with the authorities.

Disciplinary Action Against Formerly Authorised Persons

24.55 This measure allows the FCA and the PRA to take disciplinary action against firms who have committed misconduct whilst they were authorised, and who have ceased

[377] https://www.psr.org.uk/media/x3tjjuj1/psr-panel-dpi-report-may22.pdf

to be authorised on or after 20 July 2022. This will promote high standards of conduct among providers of financial services by ensuring the regulators can take decisive regulatory action to punish misconduct and prevent harm to consumers of financial services.

**Maintaining financial stability and resilience**

24.56 A stable and secure financial services sector allows for the protection and expansion of trade, investment, innovation and competition. The following measures will help protect the UK's financial stability.

Bank of England Levy

24.57 The new levy will create a stable funding mechanism for the Bank's monetary policy and financial stability functions, and so the financial services industry and the public as a whole will benefit.

Insurers in Financial Difficulties

24.58 The amendments to the arrangements for insurers in financial difficulties are expected to reduce the likelihood of significant value destruction in the event of insurer failure, which would have a detrimental impact on policyholders and the real economy. As the PRA explicitly does not operate a zero-failure supervisory regime, this pre-cautionary strengthening of the arrangements for insurers in financial difficulties will, by helping to facilitate the orderly exit of ailing firms from the market, protect the UK's financial stability by ensuring there are suitable protections in place for both policyholders and firms should an insurer fail.

Recognised Bodies: Senior Managers and Certification (SM&CR)

24.59 The Bill introduces a Senior Managers and Certification Regime (SM&CR), which can be applied to four FMIs: Central Counterparties (CCPs), Central Securities Depositories (CSDs), Credit Rating Agencies (CRAs) and Recognised Investment Exchanges (RIEs).

24.60 Introducing a SM&CR will enhance governance within firms, promote high standards of conduct and require employees to give adequate oversight to the areas for which they are responsible. This will instil greater confidence in the stability and sound governance of FMIs. The UK is home to a global clearing market used by market participants from around the world. Ensuring that the firms which underpin the proper functioning and overall stability of the UK's financial system are subject to the highest regulatory standards will help safeguard domestic and global financial and monetary stability.

24.61 Greater confidence in the stability and sound governance of these entities would in turn be of benefit to the wider market, as, for example, it would encourage firms to use CCPs and move to a cleared market. Furthermore, CCPs can achieve significant economies of scale, which help bring down the cost of clearing and transaction costs for firms. Therefore, if SM&CR leads to more confidence in CCPs and, in turn, a greater volume of transactions being cleared, the economic benefits of clearing will be greater.

Central Counterparties (CCPs) in Financial Difficulties

24.62 The proposed expansion of the UK's CCP resolution regime will ensure that, in the event of a CCP failure, the Bank has the necessary powers to stabilise a CCP, protecting financial stability by ensuring the continuation of critical clearing services. It will also protect taxpayer funds, by ensuring that losses arising from a CCP's failure will firstly be borne by the CCPs and their clearing members.

24.63 Broadly, improving the resolution regime for CCPs will improve market confidence and ensure the UK's framework aligns to international standards, helping to underpin the UK's reputation as a global hub for clearing services. Ensuring financial stability will also help promote international financial activity within the UK more widely, increasing investment and trade.

FRF Review – Regulation of FMI by the Bank of England

24.64 The new framework for the Bank's regulation of CSDs and CCPs maintains the protection of UK financial stability as its primary objective. The measure will allow the UK to move to a more comprehensive and agile model of regulation in this area, and provide the Bank with the rulemaking powers it needs to pursue this primary objective and to uphold high regulatory standards. As FMIs are systemically important firms, this will benefit not only the robustness of the firms themselves, but the wider stability of the financial system and the UK economy.

**Environmental Impacts**

24.65 In line with the government's net zero target, environmental impacts have been considered across the Financial Services and Markets Bill.

FRF Review – Objectives and Principles

24.66 The long-term effect of a strongly embedded requirement to take into account the net zero target for all financial services regulators, will mean that the rules financial services firms follow should, in future, have a more strongly embedded consideration of the government's net-zero target. Therefore, they will be more likely to lead to a sustainable, net-zero economy.

# Monitoring and Evaluation

25.1 As discussed in previous sections, except for wholesale markets review, credit unions and insurer insolvency, the remaining measures in this Bill require subsequent policy decisions and further action to be taken in the form of secondary legislation or regulator rules. The cost-benefit assessments outlined in this impact assessment are therefore indicative and will be built upon in subsequent impact assessment publications or regulator cost-benefit analysis, once details of remaining policy decisions are sufficiently mature to render it proportionate to expand the evidence base and analysis.

25.2 Similar considerations will apply for monitoring and evaluation plans for individual measures, which will not be uniform across the Bill. The measures within the Bill have a wide range of objectives, differing metrics to evaluate the respective objectives, and external factors which may affect the success of the policy and the effectiveness of the legislation.

25.3 Where the Bill requires regulators to exercise their rule-making powers, regulators are required by statute to conduct a cost-benefit analysis of their rule proposals, with no de minimis exemption. There are exemptions for a small number of specific rules, such as increasing their fees. Under the Small Business, Enterprise, and Employment Act 2015, the FCA is also required to conduct an impact assessment and submit it to the RPC for policies that cross the de minimis threshold set by the Secretary of State.

25.4 The regulators already conduct some post-implementation monitoring and evaluation of their rules. The proposed requirements for the regulators to keep their rules under review and publish a framework for reviewing their rules, under the implementation of the FRF Review in the Bill, seek to systematise this monitoring and evaluation.

25.5 For the measures in the Bill which have an impact at primary legislation stage, the monitoring and evaluation plans have been outlined in the individual chapters. They are also summarised below:

a. Wholesale markets review: a PIR will be conducted within five years the measures coming into force. Similarly, and in line with standard practice, the FCA will regularly review its rules in relation to those parts of the regime for which it is assuming responsibility.

b. Credit unions: A PIR will be conducted within five years of the measures coming into force. This review will be informed by monitoring of direct impacts and costs, primarily on credit unions through existing regular engagement with the industry.

c. Insurer Insolvency: A PIR will be conducted within five years of the measures coming into force. This review will be informed by monitoring of direct impacts and costs, primarily on insurers through existing regular engagement with the PRA, which is responsible for the prudential regulation of insurers in

the UK, and via engagement with external stakeholders including industry bodies.

25.6 For the remaining measures, where appropriate and in line with statutory requirements, the government will include review clauses in the subsequent secondary legislation. The impact assessments that accompany this secondary legislation will set out details of monitoring and evaluation specifically relevant to each policy, including the timings of any post-implementation reviews. HM Treasury will work with the relevant regulator where appropriate to undertake these reviews and ensure these are in line with the Better Regulation guidance and the principles set out in the HM Treasury Magenta Book. HM Treasury expect PIRs may be undertaken for measures such as:

a. Expanding the SM&CR: in line with existing versions of the SM&CR, the regime is expected to be subject to a PIR every five years which will commence at the point the regime comes into force for each particular type of entity.

b. Critical Third-Parties: a PIR is expected to be informed monitoring any costs that arise as a result of these proposals on critical third parties through regulator and stakeholder engagement, including critical third parties. The government will also monitor any impacts on the incidence of finance sector disruption related to critical third party incidents, also through regular engagement with the regulators.

25.7 In some cases, a PIR may not be the most suitable approach for monitoring and evaluation:

a. FMI Sandbox: FMI Sandbox: The Bill will require HM Treasury to report back to Parliament regarding what has been tested in that Sandbox, outlining how successful the testing of new technology and practices has been, and detailing the permanent changes it intends to make as a result. HM Treasury must consult the regulators in preparing this report.

b. Access to Cash (Wholesale): To ensure that the regime is meeting the policy objectives, and in the interests of wider transparency and accountability, the Bank of England (Bank) will be required to produce an annual report to HM Treasury. This report must include:

- The entities within scope of the regime and the relevant powers.
- The discharge of the Bank's functions under the regime.
- How discharging these functions has met the wholesale cash responsibility provided to the Bank under this regime.
- Other such matters as HM Treasury may from time to time direct.

25.8 It should also be noted that certain measures will not require monitoring and evaluation. These are:

a. Financial Services Compensation Scheme (FSCS) amendments: As this measure makes necessary changes resulting from FSCS's reclassification, no monitoring or evaluation is necessary or appropriate.

b. Technical Amendments to the Banking Act: minor drafting errors in legislation are being corrected, and no policy changes are being made. It is, therefore, not necessary or appropriate to monitor or evaluating this change.

25.9 Lastly, in line with the general requirement, HM Treasury will submit to the Treasury Select Committee, within three to five years of Royal Assent, a preliminary assessment of how the Act has worked in practice, relative to objectives and benchmarks identified during the passage of the Bill and in the supporting documentation.