PARLIAMENTARY DEBATES

HOUSE OF COMMONS
OFFICIAL REPORT

Second Delegated Legislation Committee

DRAFT FINANCIAL SERVICES AND MARKETS ACT 2000 (RING-FENCED BODIES, CORE ACTIVITIES, EXCLUDED ACTIVITIES AND PROHIBITIONS) (AMENDMENT) ORDER 2016

Monday 24 October 2016

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The Committee consisted of the following Members:

Chair: Sir Roger Gale

† Aldous, Peter *(Waveney)* (Con)
† Caulfield, Maria *(Lewes)* (Con)
Coffey, Ann *(Stockport)* (Lab)
† Foster, Kevin *(Torbay)* (Con)
† Glen, John *(Salisbury)* (Con)
† Griffiths, Andrew *(Lord Commissioner of Her Majesty's Treasury)*
† Jarvis, Dan *(Barnsley Central)* (Lab)
† Kerevan, George *(East Lothian)* (SNP)
† Kirby, Simon *(Economic Secretary to the Treasury)*
† Milling, Amanda *(Cannock Chase)* (Con)
† Murray, Mrs Sheryll *(South East Cornwall)* (Con)
† Reynolds, Jonathan *(Stalybridge and Hyde)* (Lab/Co-op)
† Shah, Naz *(Bradford West)* (Lab)
† Shapps, Grant *(Welwyn Hatfield)* (Con)
† Smith, Nick *(Blaenau Gwent)* (Lab)
† Tolhurst, Kelly *(Rochester and Strood)* (Con)
Winnick, Mr David *(Walsall North)* (Lab)

Clementine Brown, *Committee Clerk*

† attended the Committee

Second Delegated Legislation Committee

Monday 24 October 2016

[Sir Roger Gale *in the Chair*]

Draft Financial Services and Markets Act 2000 (Ring-fenced Bodies, Core Activities, Excluded Activities and Prohibitions) (Amendment) Order 2016

4.30 pm

The Chair: Good afternoon, ladies and gentlemen. Members may remove their jackets if they wish. Let me just put down one marker at the start of our proceedings: this statutory instrument concerns banks and banking, but that does not give Members free range to wander down every highway and byway of banking after Brexit. Please resist that temptation.

The Economic Secretary to the Treasury (Simon Kirby): I beg to move,

That the Committee has considered the draft Financial Services and Markets Act 2000 (Ring-fenced Bodies, Core Activities, Excluded Activities and Prohibitions) (Amendment) Order 2016.

It is a pleasure to serve under your chairmanship, Sir Roger. This order is a technical measure. From 1 January 2019, the ring-fencing regime will require the structural separation of core retail banking from investment banking for UK banks with retail deposits of more than £25 billion. Ring-fencing was the central recommendation of the Independent Commission on Banking, chaired by Sir John Vickers, and the Government accepted and legislated for that recommendation in the Financial Services (Banking Reform) Act 2013. Ring-fencing will continue to support financial stability by insulating retail ring-fenced banks' core services from shocks originating elsewhere in the global financial system.

The continuous provision of core services—namely, retail and small business deposits and payments services—is essential to the economy. Ring-fencing means that banks that provide those essential services become simpler and more resolvable, so core services can keep running even if a ring-fenced bank or its group fails. In so doing, ring-fencing reduces the perceived subsidy that comes from the presumption that the Government will bail out failing banks. Details of the regime are set out in secondary legislation passed in 2014, and it is some of those details that the order amends.

There are 18 different changes in the order, which will achieve three purposes: first, to address issues in the 2014 secondary legislation that could inhibit the successful implementation of the regime; secondly, to ensure that ring-fenced banks can continue recognisable retail banking activities; and thirdly, to close holes we have discovered in the ring fence. Together with the Prudential Regulation Authority, we will constantly patrol the ring fence for any flaws in the regime, and we will step in and resolve any that are identified.

To assist the Committee, I will identify the part of the order in which each of the changes can be found as I note them. Unfortunately, the order is laid out in line with the elements of the existing secondary legislation that it is amending, rather than thematically. As such, some changes require multiple amendments to different parts of the legislation, so my explanation might involve some skipping around. I am happy to provide a more detailed explanation of any aspects of the order.

The first category of amendments tackle issues in the regulations that could work against the successful implementation of the regime. Article 2 withdraws the requirement for banks' large customers to complete a burdensome qualifying declaration and also removes the requirement for banks to issue information to customers who are unaffected by the regime. Article 3(3) on page 4 also falls into that category, by allowing the securitisation of assets required in the resolution scenario under certain circumstances. It also provides for the treatment of assets held by the banking group before ring-fencing comes into effect.

Sticking with issues that could threaten implementation, article 3(6), found at the top of page 7, makes it much easier for the PRA to assess compliance with the rules relating to the selling of simple derivatives. Article 3(7) ensures consistency with the pensions regulations. Finally in this category, article 3(10), at the end of the order, addresses what happens when an organisation unexpectedly becomes a relevant financial institution while a ring-fenced bank is exposed to it.

The second set of amendments address issues with the regulations that might prevent ring-fenced banks from carrying out activities that we would certainly expect a retail bank to conduct. Amendments found in article 3(4), on page 5, will ensure that ring-fenced banks can continue to be members of payments systems and central counterparties, and that they can hedge risks within the ring fence. Articles 3(7) and 3(8), on page 7, will ensure that ring-fenced banks can manage their liquidity risk. Similarly, amendment in articles 3(9) and 3(10), on pages 7 and 8, will ensure that ring-fenced banks can continue to lend working capital to small businesses, to act as trustees, to provide consultative services and to provide loans to infrastructure projects.

The third and final set of amendments will close holes that we have discovered in the ring fence. Article 3(2), on page 4, will expand the list of global systemically important insurers to which ring-fenced banks may not be exposed. Article 3(6) on page 6 will tighten the risk calculation that constrains ring-fenced banks' issuance of simple derivatives.

To be clear, there are some things that the order does not do. It does not alter the location of the ring fence: core activities must be ring-fenced and investment banking activity must be outside the fence. It does not alter the height of the ring fence: the same degree of operational and financial independence must be observed between the ring-fenced bank and the rest of its group. It does not alter the timetable for ring-fencing: banks that are within the scope must be ring-fenced 27 months from now. We will be monitoring progress closely with the PRA and the Financial Conduct Authority.

4.37 pm

Jonathan Reynolds (Stalybridge and Hyde) (Lab/Co-op): It is a pleasure to serve under your chairmanship, Sir Roger. I thank the Minister for his opening comments.

As we have heard, the draft order will make several changes to the ring-fence regime that is due to come into force in January 2019. As a result of the structural

changes that the banks have begun to implement ahead of the regime's introduction, the Treasury has suggested that a number of technical issues have become apparent that, if not rectified, could undermine the regime's effectiveness. Any moves to fix legislative error and confusion are of course welcome. In fact, it is clear to the Opposition that there is an urgent need for consolidated legislation in this regulatory area.

Even commercial providers will not provide a complete, up-to-date version of the Financial Services and Markets Act 2000 and its successor legislation and statutory instruments. As such, it is very difficult indeed for practitioners to know exactly what the law currently is. Leaving it all in such a piecemeal mess—there has been legislation in 2012, 2013, 2014 and 2015 to make detailed amendments to already detailed provisions—is unacceptable and causes confusion for everyone involved. Will the Minister confirm whether the Government have plans to rectify the situation?

I notice that there is no regulatory impact assessment for the draft order, although the explanatory memorandum states that the Treasury will prepare a "validation impact assessment" for at least one of the changes: specifically, the removal of the qualifying declaration process. As my Front-Bench colleague in the other place has pointed out, surely it would have been wise to produce an assessment before the policy was introduced, or at least before the order was laid. The Government have until January 2019 to get this matter right, so why is it being rushed through and the correct assessment procedure not being followed? When will the validation impact assessment be published?

I have several questions for the Minister on the specifics of the regulation, in order to clarify the intent and purpose of some of the changes outlined. In particular, the Opposition are today seeking categorical assurances from the Government that the draft order does not contain any measures that could potentially allow different types of activity to slip past or weaken the protection of the ring fence. There is potentially a problem in that the Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014 sets out exceptions to the prohibition on excluded activities that cannot be conducted by retail banks. Can the Minister confirm that no provision in the draft order could potentially provide a way around the general principle that there must be separation between different types of entity?

As hon. Members will be aware, the Financial Services and Markets Act 2000 works by providing general principles, for example the section 19 prohibition on conducting financial services without authorisation from the Financial Conduct Authority, and then having secondary legislation, for example the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, lay out the exceptions from that general rule. I therefore seek clarification that this regulation does not excuse the banks and others from being bound by the general principles in the statute.

I have specific concerns about the measures in article 2 to amend the Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014 to make new provision regarding the identification of qualifying organisations. Instead of a relevant organisation being required to give a "qualifying organisation declaration" to a UK deposit taker before it may be considered a qualifying organisation, it is proposed, as the Minister outlined, that a UK deposit taker may determine that an organisation is a qualifying organisation without that organisation having to give any such declaration. However, other regulations—for example, the prospectus regulations in securities law—make plain the sorts of information, or at the very least the categories of information, that must be established.

In comparison, these provisions seem worryingly loose and quite unclear. If the test of a good rule is whether we can know when it has been broken, how will we know when a bank has breached that proposed new rule? Why should a bank be making a decision about the status of an entity where that entity is not yet prepared to provide a balance sheet? Does this apply only to new companies—for example, a new subsidiary, in which case the parent should know the capital being assigned to it—or to companies that are unknown to the bank? If the latter is the case, why is it dealing with them for this purpose? Whether or not an organisation was part of the same group as a qualifying organisation would surely be a matter of fact. In what circumstances will banks be dealing with any entity where that is not clear?

More fundamentally, Labour is concerned about whether any ring fence will actually be able to protect the system, consumers and other financial institutions against the failure of an entity that cannot then find the money to pay back or transfer back whatever is owed to a protected entity. There are genuine, legitimate and serious questions about whether a ring fence, which allows transactions between group companies, is really any protection at all. The retail bank could still be funding the speculations by the investment bank even if the contracts purport to create a right to be repaid for the retail bank. As soon as a crisis strikes, debts will simply not be repaid, and there will be no money in the system to make repayment in full because investment banks will not hoard cash; instead, they will spend it and use it as leverage to borrow more money to speculate with.

As we continue to discover, there is much confusion about what falls on either side of the ring fence. That lack of clarity makes regulation very difficult. However, Labour Members are very clear that never again should we hand the dice back to the gamblers. We know that people and society want and need banks in which they can safely deposit their money and savings and that lend responsibly and provide credit to finance investment growth across the country. People deserve a much more holistic approach than the piecemeal approach that we have seen so far to legislation. What is required is an unswerving commitment to transform the sector and ensure responsible financing.

We will always support financial services where they deliver a clear benefit to the whole community, but we should all recognise that the level of anger that still exists following the financial crisis must be responded to. Getting the ring fence right is a key part of addressing that anger. I would be grateful to the Minister for his response today to the points I have raised.

4.43 pm

George Kerevan (East Lothian) (SNP): It is a great pleasure to serve under your chairmanship, Sir Roger. I shall not detain the Committee terribly long, or challenge the order, but I do wish to place on the record some

[George Kerevan]

concerns I have, which I hope will be taken away by the Minister and, in due course, noted by the regulatory authorities.

We do not yet have the ring fence. In fact, it will take a whole six years from the initial legislation in 2013 to the ring fence coming into operation in 2019, which is rather a long time, and we will not know whether it is working until some considerable time after that. It is a major experiment, given that we are trying to solve a problem that occurred way back in 2007-08.

My concern, which is shared by a number of colleagues on the Treasury Committee—that is why I feel emboldened to raise it today—is that the length of time it is taking to get the ring fence in place is leading to a bit of regulatory arbitrage on the part of the banks. I understand that—I am not being particularly censorious—but the banks are clearly trying to ensure that the details of the ring fence are placed best for their business, to give them the widest flexibility in business. I understand that, but six years is rather a long time for them to nibble away at the principle of the original legislation.

Two issues in the proposals give me a bit of concern. Let us just remind ourselves that the ring fence is meant to stop the retail side of banks dealing in investments in a way that leads to institutional exposure that it ultimately falls back on the taxpayer to cover. The proposal to loosen the regulation on banks acting as trustees and investing on behalf of clients' trusts seems, at first, to be innocuous. The draft notes from the Treasury mentioned widows and orphans, and it sounded very much like old-fashioned banking, but anyone who knows anything about contemporary retail banking knows that retail banks are keen to expand their activities on behalf of high-net-worth clients all over Europe.

The changes in the order in fact open the door to retail banks investing heavily, in a very expanded way, on behalf of private clients, here and across the EU and the European economic area. That might be a sensible reform, but it is a door that could be opened ever wider by commercial banks, particularly when we have a runaway boom. Will the Treasury look at that carefully? If all that is intended is to ensure normal investment activity on behalf of small trusts and private clients—the average widow—then fine. But if it is going to allow more than that, the Treasury needs to look at these rules in greater detail.

The other issue of modest concern is allowing the retail side of the ring fence to invest directly in special vehicles for infrastructure investment. The order specifically states that that covers infrastructure investment across the whole European economic area, not just the UK. The draft rules specify the specific areas covered by investment infrastructure and clearly rule out investment in commercial property. That is a very good thing because, looking back to the run-up to 2007, commercial banks on the retail side got themselves into serious trouble—particularly Halifax and the Royal Bank of Scotland—by investing in a proprietary way in commercial property. That seems to be ruled out and I just want the Minister to reassure me of that.

The other areas where retail banks could find themselves being exposed to institutional risk by investing directly in infrastructure include housing and energy, which I presume would include something such as Hinkley Point. Large amounts of money could be involved, and although in principle that is not something one would be opposed to, in periods when the market runs away with itself it opens up the prospect of banks taking undue risk.

I will finish on this point. We have slightly opened the door to retail banks engaging in investment in their own name and therefore exposing themselves to institutional risk in a way that was not there before the rules came up for amendment. I want to be sure that the Treasury has looked at that and will keep a watching brief on it, because a potential danger lurks there.

4.49 pm

Simon Kirby: I welcome the hon. Member for Stalybridge and Hyde to his new post. I wish him all the very best and hope to see him there for a long time to come.

I will make some general comments before moving on to the specific points. It has been a thoughtful and helpful conversation. This will not be the final opportunity for Parliament to provide scrutiny of the details of the ring-fencing regime. In its annual report, which the Treasury must lay before Parliament, the PRA will be obliged to report on compliance with ring-fencing and the banks' use of exemptions. That will add transparency and ensure that exemptions are used only for the purpose intended. The PRA must also carry out regular reviews of its rules and provide a report to be laid before Parliament.

Section 8 of the Financial Services (Banking Reform) Act 2013 also obliges the Government to appoint a post-implementation review within two years of the separation date to monitor the implementation of the ring-fencing regime. That review will also report to Parliament and allow scrutiny on whether the legislation is working as intended. As banks complete their implementation plans and the regime comes into force, the Treasury and the PRA will continue to patrol the ring fence to ensure that it remains robust. We have come forward with amendments to ensure that the regime works and to close holes in the fence today. Should we discover further need, we will act again.

As recommended by the Parliamentary Commission on Banking Standards, the ring fence is electrified. With electrification, trying to game the regime, second-guess it or pass unwarranted business through the fence poses a serious cost. If the rules are flouted, the PRA can impose, with the Treasury's consent, the complete separation of a banking group. Our vigilance, combined with the electrification powers supported by the Treasury Committee, should provide a powerful disincentive to attempts to undermine the ring fence. That should deliver an effective, robust regime that supports financial stability while ensuring that the benefits our banks provide to the UK real economy continue.

I was asked about consolidation. Commercial providers will in due course produce consolidated versions of the delegated legislation. There is no prospect of the SMA being consolidated. I was also asked why we did not produce an impact assessment. These amendments are mainly technical changes to the ring-fencing regulation. The Regulatory Policy Committee rules state that the deregulatory nature of this change means that we do not need to prepare a regulatory impact assessment. We do not normally publish validation impact assessments, but in this case I will be happy to do so, once it has been validated by the RPC.

I was asked to confirm that the arrangement would not allow banks a way around segregation. I can absolutely confirm that. On the qualifying declaration, can we be sure that banks will get that right? A banking group that wrongly places a small business deposit into a non-ring-fenced bank places itself at huge risk. That would have serious consequences, including the PRA potentially taking enforcement action. Therefore, that risk is minimised.

I was asked about infrastructure investment. I can reassure the Committee that commercial property is ruled out. Of course, any investment involves risk, but there is a strong need to be able to fund infrastructure from a variety of funding sources, including customer deposits. We will monitor use of that provision to ensure that it is used appropriately.

On the subject of trustees, banks must report use of exemptions to the PRA, which will then report to Parliament. We and the PRA will exercise constant vigilance to step in if we see any abuse whatsoever. Providing trustee services of individuals and charities does not give scope for the ring-fenced body to incur risks itself as a proprietary trader.

I hope that I have covered everything. These are important changes. Although technical and complicated, their intention is to provide the best possible solution for the banks, the banks' customers and, ultimately, all of us as consumers.

Question put and agreed to.

4.55 pm

Committee rose.