EXPLANATORY MEMORANDUM TO

THE FINANCIAL HOLDING COMPANIES (APROVAL ETC.) AND CAPITAL REQUIREMENTS (CAPITAL BUFFERS AND MACRO-PRUDENTIAL MEASURES) (AMENDMENT) (EU EXIT) REGULATIONS 2020

2020 No.

1. Introduction

1.1 This explanatory memorandum has been prepared by the Treasury and is laid before Parliament by Command of Her Majesty.

2. Purpose of the instrument

2.1 This instrument implements Directive (EU) 2019/878 of the European Parliament and of the Council, known as the Capital Requirements Directive V (CRDV). The Directive amends the EU's Capital Requirements Directive IV (Directive 2013/36/EU) (CRDIV), in order to address issues raised in relation to the provisions of CRDIV that proved not to be sufficiently clear and have therefore been subject to divergent interpretations or that have been found to be overly burdensome for certain institutions (institutions means banks or investment firms; for the purposes of this instrument, institutions in scope are banks and systemic investment firms).

2.2 The EU's prudential regime for banks, building societies and investment firms includes the Capital Requirements Regulation (CRR) and the CRDIV, together with a range of Binding Technical Standards (BTS).

2.3 These pieces of legislation are the vehicle for the EU's implementation of the international Basel accords, a set of prudential standards predominantly developed in the aftermath of the financial crisis by the Basel Committee on Banking Supervision (BCBS), which the UK contributes to through the membership of the Prudential Regulation Authority (PRA) and the Bank of England. Prudential regulation ensures firms have enough capital and liquidity to operate effectively through periods of economic stress without causing harm to the wider financial system.

2.4 CRR is directly applicable. CRDIV was implemented in UK legislation through the Capital Requirements Regulations 2013, the Capital Requirements (Country-by-Country Reporting) Regulations 2013 (SI 2013/3118), the Capital Requirements (Capital Buffers and Macroprudential Measures) Regulations 2014 (SI 2014/894), and regulator rules.

2.5 The BCBS agreed the first phase of the Basel III reforms beginning in December 2010. These standards sought to strengthen the provisions of the existing Basel framework in a number of areas, notably the quality and quantity of capital banks are required to hold, in order to provide better protections against the range of risks which banks are exposed to. The EU implemented the Basel III reforms agreed in December 2010 primarily through the CRD IV package of reforms and the CRR.

2.6 The Capital Requirements Regulation II (CRR II) - which amends CRR - and CRD V implement some of the remaining Basel III reforms finalised after 2012. In addition to the transposition of CRDV, the UK will implement the remaining Basel standards via the Financial Services Bill, including those being implemented in the EU through CRR II, as well as the internationally agreed Basel 3.1 standards.

2.7 HMT's implementation of CRDIV delegated significant responsibility to the PRA. Therefore, this instrument only contains provisions which are legislatively necessary to update the UK's implementation of CRDIV (to reflect the amendments to CRDIV that have been made by CRDV). This includes providing the PRA with new or updated powers to implement CRDV, and to ensure that the PRA can update its rulebook as needed.

2.8 In addition, this instrument addresses deficiencies in retained EU law arising from the withdrawal of the UK from the EU.

Explanations

What did any relevant EU law do before exit day?

2.9 The prudential framework which currently exists in the UK was made before the end of the Transition Period. This means that this legislation includes various references to European processes/institutions.

Why is it being changed?

2.10 Now that the UK has left the EU these references will no longer be appropriate as the UK will no longer be part of those processes/institutions.

What will it now do?

2.11 This instrument removes EU references and arrangements from aspects of the capital requirements legislative framework, in areas where such language will no longer be appropriate after the end of the Transition Period.

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None.

Matters relevant to Standing Orders Nos. 83P and 83T of the Standing Orders of the House of Commons relating to Public Business (English Votes for English Laws)

3.2 The territorial application includes Scotland and Northern Ireland.

3.3 The powers under which this instrument is made cover the entire United Kingdom and the territorial application of this instrument is not limited by either the Act or by the instrument.

4. Extent and Territorial Application

4.1 The territorial extent of this instrument is the whole of the United Kingdom.

4.2 The territorial application of this instrument is the whole of the United Kingdom.

5. European Convention on Human Rights

5.1 The Economic Secretary to the Treasury (John Glen MP) has made the following statement regarding Human Rights:

"In my view the provisions of The Financial Holding Companies (Approval etc.) and Capital Requirements (Capital Buffers and Macro-prudential Measures) (Amendment) (EU Exit) Regulations 2020 are compatible with the Convention rights."

6. Legislative Context

6.1 CRDV, alongside CRRII, continues the EU's implementation of further elements of the internationally agreed Basel framework, set by the BCBS.

6.2 The United Kingdom has a legal obligation under the Withdrawal Agreement to transpose EU Directives that come into force during the Transition Period. This includes the transposition of CRDV by 28 December 2020.

6.3 Much of CRDV builds on CRDIV. The Government's implementation of CRDIV delegated significant responsibility to the PRA. The Government intends to maintain the split of responsibility as introduced through CRDIV and is therefore only legislating where the PRA cannot already make rules under its existing powers under the Financial Services and Markets Act 2000.

6.4 The Government will, through the Financial Services Bill, facilitate the implementation of the outstanding Basel III reforms.

7. Policy background

What is being done and why?

7.1 As seen by the global financial crisis of 2007-09, ensuring the stability of the banking sector is vital to the underlying economy. This sector provides essential services to the economy, such as deposit taking, the facilitation of payments and the provision of credit. However, during the financial crisis, UK banks made large losses and were insufficiently capitalised under the previous framework. This had an adverse impact on the real economy and resulted in a fall in lending and large bailouts using taxpayer's money.

7.2 International standards were updated through Basel III to address the shortcomings identified in the financial crisis. The EU has implemented many of these standards through CRR and CRDIV.

7.3 HM Treasury's CRDV implementation updates the current EU prudential regime by: exempting non-systemic investment firms; creating a holding company approval regime, and requiring certain holding companies to be responsible for sub-consolidated and consolidated prudential requirements; updating the macro-prudential tools available to Member States (which includes the UK until implementation completion day); and updating the confidential information-sharing regime with international bodies.

Exemption for non-systemic investment firms

7.4 CRR and CRDIV, although created with banks in mind, also apply to investment firms. Unlike credit institutions, investment firms do not typically take deposits or grant traditional loans. This means that the risks faced and posed by investment firms, whilst overlapping to some extent, are different to those of credit institutions. While providing for some exemptions to accommodate these differences, the prudential regulatory framework and its patchwork of exemptions has become more and more complex to navigate and they are no longer fit-for-purpose for the regulation of investment firms.

7.5 To address this, the EU introduced a new regime - Investment Firms Regulation (IFR) and Investment Firms Directive (IFD) which were published in the Official Journal of the European Union in December 2019. The UK played an instrumental role in the introduction of the regime at EU level, negotiated it as a Member State, and is supportive of its intended outcomes. However, as this regime only applies from 26 June 2021 – which is after the end of the implementation – it will not apply in the UK.

7.6 The Government is therefore legislating through the Financial Services Bill to introduce a new prudential regime for investment firms – the Investment Firms Prudential Regime (IFPR). This new regime will broadly reflect the EU's IFR/IFD but will be tailored to the UK.

7.7 With that in mind, the UK's implementation of CRDV, through this instrument, will not apply to non-systemic (FCA regulated) investment firms to whom the IFPR will apply (except where making consequential amendments to existing provisions).

<u>*Holding companies' approval regime*</u>

7.8 Large banks are often structured such that business is carried out by a collection of subsidiaries under the umbrella of a single parent holding company. These holding companies have limited operational responsibilities but instead serve as the parent entity for legal and financial purposes.

7.9 CRRII changes the entity responsible for banking groups (and those including a systemic investment firm(s)) meeting their consolidated prudential requirements from operating companies to approved parent holding companies.

7.10 These changes will be beneficial to the UK's financial stability as they close a gap in the PRA's ability to regulate and supervise large financial institutions. Holding companies are often the level at which important decisions are made and therefore making them responsible for consolidated requirements will lead to more efficient supervision, since rules for the group could be written and enforced at the level at which the relevant decisions are taken.

7.11 This instrument creates a bespoke approval regime for holding companies, in line with Article 21a of CRDV. This instrument also transposes provisions in CRDV which specify that parent holding companies can be exempt from approval where specific conditions are met. Those conditions relate to the level of effective control over the group or its bank, investment firm or other financial institution subsidiaries.

7.12 The PRA will be responsible for enforcing supervisory measures on holding companies that fail to comply with the approval conditions. To support this, this instrument transposes Article 21a(6) of CRDV, which allows the PRA to apply measures including:

- issuing directions or penalties against the holding company or the members of the management body and managers
- designating, on a temporary basis, another holding company or institution within the group as responsible for ensuring compliance with consolidated requirements
- restricting or prohibiting distributions or interest payments to shareholders requiring the holding company to divest from or reduce holdings in institutions or other financial sector entities
- requiring the holding company to submit a plan on return, without delay, to achieve compliance
- suspending the exercise of voting rights attached to the shares of the subsidiary institutions held by the financial holding company
- giving directions to the holding company to transfer to its shareholders the holdings in its subsidiary institutions.

7.13 This instrument allows for a transition period under which the parent holding company will be deemed to be approved until the PRA reaches a decision on approval.

7.14 This instrument will also allow the PRA to designate one or more financial holding companies, mixed financial holding companies or institutions within the group of which the holding company or institution forms part as being responsible for ensuring that the group complies with the prudential requirements on a consolidated or sub-consolidated basis until such time as the PRA reaches it approval decision.

Removal of members from management boards

7.15 In line with Article 91 of CRDV, this instrument grants the PRA an express power to remove members of the management body of institutions and holding companies if they are found no longer to be of sufficiently good repute, no longer have the right skills, knowledge, experience, honesty or integrity, or are unable to commit sufficient time for the role.

Confidential information

7.16 This instrument will permit the PRA to disclose information to certain approved international bodies, without the firm's permission – including the International Monetary Fund, the World Bank, the Bank for International Settlements, and the Financial Stability Board - as required by Article 58a of CRDV.

7.17 The PRA will only be able to provide the relevant information to the international bodies if the following conditions are met:

- the organisation must make an explicit request for the confidential information
- the request is precise as to the nature, scope and format of the confidential information and the means of its disclosure of transmission
- the confidential information requested is necessary for the performance of the specific tasks of the organisation making the request and does not go beyond the functions conferred on that organisation
- the organisation making the request justifies it by reference to its tasks
- to the extent that the disclosure of confidential information involves processing of personal data, any processing of personal data by the organisation making the request complies with the UK GDPR.
- Article 56 of CRDV currently permits the exchange of information between competent authorities and seven types of body in paragraphs (a) to (g).

7.18 This instrument inserts two additional types of body to this list in the Financial Services and Markets Act 2000 (Disclosure of Confidential Information) Regulations 2001, in accordance with CRDV:

(i) authorities responsible for supervising financial intelligence units, and

(ii) competent authorities or bodies responsible for the application of rules on structural separation within a banking group.

Macro-prudential updates

7.19 CRDV clarifies how certain macro-prudential tools should be used, in particular:

- CRDV clarifies that only the Other-Systemically Important Institutions (O-SII) buffer should be used to address the risks posed by the domestic systemic importance of large UK firms, not the Systemic Risk Buffer (SRB) currently in CRDIV; and

- CRDV clarifies that Pillar 2 capital requirements, which is a type of capital set by supervisors to address risks not fully captured by other forms of minimum capital requirements, cannot be used for macro-prudential purposes. However, CRDV amends the Systemic Risk Buffer (referred to here as the CRDV SRB) to enable it to perform some of the macro-prudential functions previously performed by Pillar 2, specifically the ability to set Sectoral Capital Requirements (SCRs).

7.20 This instrument will implement the relevant changes in order to preserve the Financial Policy Committee's (FPC), the UK's macro-prudential authority, and PRA's current level of macro-prudential policy flexibility.

7.21 This instrument will give the PRA the power to apply an O-SII buffer to require ring-fenced banks and large building societies to hold capital up to 3% of risk exposures (using Common Equity Tier 1 capital). The legislation will also provide for the FPC to develop a framework to guide the setting of the O-SII buffer. In this way the instrument ensures the O-SII buffer can perform the functions currently performed by the CRDIV Systemic Risk Buffer. The PRA announced on 9 April 2020 that it intends to maintain current rates set under the CRDIV SRB, and any relevant successor buffer rates under CRDV (in this case the O-SII buffer), with a reassessment in December 2021.[1]

7.22 This instrument also gives the PRA a power to apply the CRDV SRB. This compensates for the limitations CRDV places on using Pillar 2 capital for macro-prudential purposes and ensures the preservation of the FPC's and PRA's current level of macro-prudential flexibility. This is to enable the PRA to continue to be able to set Sectoral Capital Requirements (SCRs). SCRs are a tool whereby the regulator makes financial institutions hold additional capital for their exposures to certain sectors/sub-sectors (e.g. to commercial property).

7.23 The SRB can be used to apply SCRs to credit institutions and PRA-designated investment firms, and their groups. The FPC and PRA have never used SCRs for macro-prudential purposes, so none are currently in place. The changes necessary to limit the PRA's ability to use Pillar 2 capital requirements for macro-prudential purposes are also contained in this instrument.

7.24 This instrument updates the definitions of Other Systemically Important Institutions (O-SIIs) and Globally Systemically Important Institutions (G-SIIs), following the changes set out in Article 131 of CRDV. It also makes clear that the PRA may apply the counter-cyclical capital buffer and the capital conservation buffer at the level of approved holding companies to meet sub-consolidated or consolidated requirements, in line with the broader changes made in relation to holding companies.

7.25 In addition, this instrument will designate the PRA as the competent authority for the purpose of Articles 124 and 164 of CRR. This is required to allow the PRA to exercise discretion to ensure the capital requirements applied to risks in sectors/subsectors like real estate are appropriately prudent to ensure financial stability.

7.26 The PRA has invited comment on its proposed approach to the implementation of certain measures relevant to the transposition of CRDV and CRRII in its consultation

[1] https://www.bankofengland.co.uk/prudential-regulation/publication/2020/pra-decision-on-srb-rates

which concluded on 30 September 2020.[2] Industry will have a further opportunity to comment as the PRA intend to consult further in the autumn of 2020.

8. European Union (Withdrawal) Act/Withdrawal of the United Kingdom from the European Union

8.1 This instrument is being made using the power in section 8 of the European Union (Withdrawal) Act 2018, in order to address failures of retained EU law to operate effectively or other deficiencies arising from the withdrawal of the United Kingdom from the European Union. In accordance with the requirements of that Act the Minister has made the relevant statements as detailed in Part 2 of the Annex to this Explanatory Memorandum.

8.2 Alongside the EU (Withdrawal) Act 2018 powers, this instrument is also being made under section 2(2) of the European Communities Act 1972 (c.68) as saved by section 1(A) of the European Union (Withdrawal Agreement) Act 2020, to amend primary and secondary legislation in order to transpose CRDV.

9. Consolidation

9.1 This instrument will not consolidate other instruments.

10. Consultation outcome

10.1 HM Treasury ran a public consultation on the transposition of CRDV, which opened on 16 July 2020 and closed on 19 August 2020. The consultation focussed on the key CRDV changes which HM Treasury intends to legislate. HM Treasury received eight formal responses to the consultation, all from financial institutions and industry bodies. It has examined and considered each carefully. Respondents broadly agreed with HM Treasury's proposed positions.

10.2 Firms that responded highlighted agreement with HM Treasury's overall approach to the implementation of the holding company approval regime. Several responses also highlighted agreement with the PRA's proposed approach to the non-implementation of intermediate parent undertaking requirements that come into force after the end of the transposition period, expressed in its consultation.[3] In addition, firms were supportive of our intention to exempt investment firms from the scope of CRDV and accepted the need to make the proposed changes to preserve existing flexibility the macro-prudential framework.

10.3 A more detailed analysis of the consultation outcome and the Treasury's policy response to the opinions expressed can be found at: https://www.gov.uk/government/consultations/consultation-on-updating-the-uks-prudential-regime-before-the-end-of-the-transition-period

11. Guidance

11.1 HM Treasury does not propose to issue guidance on the content of these Regulations. The PRA will, in due course, consult on and update their rules accordingly.

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[2] https://www.bankofengland.co.uk/prudential-regulation/publication/2020/capital-requirements-directive-v
[3] https://www.bankofengland.co.uk/prudential-regulation/publication/2020/capital-requirements-directive-v

12. Impact

12.1 There is no, or no significant, impact on business, charities or voluntary bodies.

12.2 There is no, or no significant, impact on the public sector.

12.3 An Impact Assessment has not been prepared for this instrument because in line with Better Regulation guidance, HM Treasury considers that the net impact on businesses will be less than £5 million a year. Due to this limited impact, a de-minimis impact assessment has been carried out.

13. Regulating small business

13.1 The legislation applies to activities that are undertaken by small businesses.

13.2 The only small businesses that this instrument applies to are PRA regulated firms if they currently fall in scope of the CRD and CRR regimes. The Government does not consider there is a further need to minimise the impact of the requirements on small businesses (employing up to 50 people). This instrument aims to ensure the UK has a functioning prudential regime, consistent with the requirements of CRDV.

13.3 The main changes within this instrument are primarily relevant to larger financial institutions; for example, the introduction of the O-SII buffer is only relevant to large financial institutions. The Government has also exempted FCA-regulated institutions from the main provisions in this instrument, minimising the impact on small businesses. While the CRDV systemic risk buffer and the approval regime for holding companies could technically apply to smaller financial institutions, the Government does not expect material incremental impacts on small businesses in practice.

13.4 In the case of the CRDV SRB, this change is intended to maintain an existing ability to set Sectoral Capital Requirements. The Government also considers it highly unlikely that smaller institutions will in practice to set up a holding company, meaning the practical effect of these provisions on small businesses should be very limited.

14. Monitoring & review

14.1 As this instrument is made under the EU (Withdrawal) Act 2018, no review clause is required.

15. Contact

15.1 Toby Coaker at toby.coaker@hmtreasury.gov.uk can be contacted with any queries regarding the instrument.

15.2 Tom Duggan, Deputy Director for Securities, Markets and Banking, at HM Treasury can confirm that this Explanatory Memorandum meets the required standard.

15.3 The Economic Secretary to the Treasury (John Glen) can confirm that this Explanatory Memorandum meets the required standard.

Annex

Statements under the European Union (Withdrawal) Act 2018

Part 1

Table of Statements under the 2018 Act

This table sets out the statements that may be required under the 2018 Act.

Statement	Where the requirement sits	To whom it applies	What it requires
Sifting	Paragraphs 3(3), 3(7) and 17(3) and 17(7) of Schedule 7	Ministers of the Crown exercising sections 8(1), 9 and 23(1) to make a Negative SI	Explain why the instrument should be subject to the negative procedure and, if applicable, why they disagree with the recommendation(s) of the SLSC/Sifting Committees
Appropriate-ness	Sub-paragraph (2) of paragraph 28, Schedule 7	Ministers of the Crown exercising sections 8(1), 9 and 23(1) or jointly exercising powers in Schedule 2	A statement that the SI does no more than is appropriate.
Good Reasons	Sub-paragraph (3) of paragraph 28, Schedule 7	Ministers of the Crown exercising sections 8(1), 9 and 23(1) or jointly exercising powers in Schedule 2	Explain the good reasons for making the instrument and that what is being done is a reasonable course of action.
Equalities	Sub-paragraphs (4) and (5) of paragraph 28, Schedule 7	Ministers of the Crown exercising sections 8(1), 9 and 23(1) or jointly exercising powers in Schedule 2	Explain what, if any, amendment, repeals or revocations are being made to the Equalities Acts 2006 and 2010 and legislation made under them. State that the Minister has had due regard to the need to eliminate discrimination and other conduct prohibited under the Equality Act 2010.
Explanations	Sub-paragraph (6) of paragraph 28, Schedule 7	Ministers of the Crown exercising sections 8(1), 9 and 23(1) or jointly exercising powers in Schedule 2 In addition to the statutory obligation the Government has made a political commitment to include these statements alongside all EUWA SIs	Explain the instrument, identify the relevant law before exit day, explain the instrument's effect on retained EU law and give information about the purpose of the instrument, e.g., whether minor or technical changes only are intended to the EU retained law.
Criminal offences	Sub-paragraphs (3) and (7) of paragraph 28, Schedule 7	Ministers of the Crown exercising sections 8(1), 9, and	Set out the 'good reasons' for creating a criminal offence, and the penalty attached.

		23(1) or jointly exercising powers in Schedule 2 to create a criminal offence	
Sub-delegation	Paragraph 30, Schedule 7	Ministers of the Crown exercising sections 10(1), 12 and part 1 of Schedule 4 to create a legislative power exercisable not by a Minister of the Crown or a Devolved Authority by Statutory Instrument.	State why it is appropriate to create such a sub-delegated power.
Urgency	Paragraph 34, Schedule 7	Ministers of the Crown using the urgent procedure in paragraphs 4 or 14, Schedule 7.	Statement of the reasons for the Minister's opinion that the SI is urgent.
Explanations where amending regulations under 2(2) ECA 1972	Paragraph 14, Schedule 8	Anybody making an SI after exit day under powers outside the European Union (Withdrawal) Act 2018 which modifies subordinate legislation made under s. 2(2) ECA	Statement explaining the good reasons for modifying the instrument made under s. 2(2) ECA, identifying the relevant law before exit day, and explaining the instrument's effect on retained EU law.
Scrutiny statement where amending regulations under 2(2) ECA 1972	Paragraph 15, Schedule 8	Anybody making an SI after exit day under powers outside the European Union (Withdrawal) Act 2018 which modifies subordinate legislation made under s. 2(2) ECA	Statement setting out: a) the steps which the relevant authority has taken to make the draft instrument published in accordance with paragraph 16(2), Schedule 8 available to each House of Parliament, b) containing information about the relevant authority's response to— (i) any recommendations made by a committee of either House of Parliament about the published draft instrument, and (ii) any other representations made to the relevant authority about the published draft instrument, and, c) containing any other information that the relevant authority considers appropriate in relation to the scrutiny of the instrument or draft instrument which is to be laid.

Part 2

Statements required when using enabling powers under the European Union (Withdrawal) 2018 Act

1. Appropriateness statement

1.1 The Economic Secretary to the Treasury, John Glen, has made the following statement regarding use of legislative powers in the European Union (Withdrawal) Act 2018:

"In my view, The Financial Holding Companies (Approval etc.) and Capital Requirements (Capital Buffers and Macro-prudential Measures) (Amendment) (EU Exit) Regulations 2020 does no more than is appropriate".

1.2 This is the case because: this instrument only uses the enabling power under the European Union (Withdrawal) 2018 to correct references to EU processes and institutions in areas where those references are no longer appropriate now that the UK has left the EU.

2. Good reasons

2.1 The Economic Secretary to the Treasury, John Glen, has made the following statement regarding use of legislative powers in the European Union (Withdrawal) Act 2018:

"In my view there are good reasons for the provisions in this instrument, and I have concluded they are a reasonable course of action".

2.2 This is the case because: without the corrective measures being made under European Union (Withdrawal) Act 2018, the UK's prudential legislative framework would not function effectively at the end of the Transition Period. For example, without these corrective measures the UK could continue to be bound by EU institutions such as the European Banking Authority or the commission, which would be no longer appropriate now that the UK has left the EU.

3. Equalities

3.1 The Economic Secretary to the Treasury, John Glen has made the following statement:

"The Financial Holding Companies (Approval etc.) and Capital Requirements (Capital Buffers and Macro-prudential Measures) (Amendment) (EU Exit) Regulations 2020 does not amend, repeal or revoke a provision or provisions in the Equality Act 2006 or the Equality Act 2010 or subordinate legislation made under those Acts.

3.2 The Economic Secretary to the Treasury, John Glen has made the following statement regarding use of legislative powers in the European Union (Withdrawal) Act 2018:

"In relation to the Financial Holding Companies (Approval etc.) and Capital Requirements (Capital Buffers and Macro-prudential Measures) (Amendment) (EU Exit) Regulations 2020, I, the Economic Secretary to the Treasury, John Glen, have had due regard to the need to eliminate discrimination, harassment, victimisation and any other conduct that is prohibited by or under the Equality Act 2010.".

4. Explanations

4.1 The explanations statement has been made in section 2 of the main body of this explanatory memorandum.