HM Treasury

Prudential standards in the Financial Services Bill: June update

Policy statement

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Chapter 1

Prudential standards in the Financial Services Bill: June update

Background

1.1 At the 11 March Budget, the government published its intention to update the prudential regime for banks to enable the implementation of Basel 3.1 and a UK version of the second Capital Requirements Regulation (CRRII). The government also announced that it will legislate to enable the UK to introduce a new prudential regime for investment firms.

1.2 This policy statement provides an update on the proposed approach to legislating this package of prudential standards within the Financial Services (FS) Bill.

1.3 In due course, the Regulators will provide further detail in relation to the elements of the standards for which they have responsibility.

1.4 In that context, the Financial Conduct Authority (FCA) is also publishing a discussion paper in relation to the new prudential regime for investment firms.

Current legislative context

The banking regime

1.5 On 1 January 2014, the Capital Requirements Regulation (CRR) and fourth Capital Requirements Directive (CRDIV) became applicable in the European Union. This legislation began the implementation of the "Basel III" international standards of the Basel Committee on Banking Supervision (BCBS) in European law, thereby amending prudential requirements for banks, building societies and investment firms.

1.6 More recently, the EU has legislated to introduce further elements of the Basel framework through CRRII and the fifth Capital Requirements Directive (CRDV).

1.7 Although some parts of CRRII will apply before the end of the Transition Period, a number of provisions will apply in the EU from June 2021. As this is after the end of the Transition Period, these elements will not automatically apply in the UK.

1.8 Unlike CRRII, CRDV must be transposed into national legislation by 28 December 2020.

1.9 The BCBS finalised the Basel III standards with a series of amendments, sometimes referred to as Basel 3.1. Most Basel 3.1 revisions are not included in CRRII and CRDV and have not yet been legislated for in the EU or the UK.

The investment firms regime

1.10 The unamended CRR/CRD, although created with banks in mind, also applies to investment firms. Unlike credit institutions, investment firms do not take deposits or grant traditional loans. This means that the risks faced and posed by investment firms are different to those of credit institutions. Whilst 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 is no longer fit-for-purpose for the regulation of investment firms.

1.11 To address this, the EU introduced a new regime - the Investment Firms Regulation and Directive (IFR/IFD) – which was 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 Transition Period – it will not automatically apply in the UK.

1.12 As part of the FS Bill, HM Treasury is legislating new UK frameworks to update prudential rules for banks and to introduce a new prudential regime for investment firms – the Investment Firms Prudential Regime (IFPR).

HM Treasury's legislative approach

1.13 As set out at Budget, HM Treasury is committed to four overarching principles when legislating prudential standards in the Financial Services Bill[1]:

a. financial stability and, where relevant, the implementation of international standards, in particular the Basel III and 3.1 standards. The UK is signed up to these standards as a member of the G20;

b. supporting the government's wider objectives on growth, competition, and competitiveness;

c. a central role for the expert, independent UK Regulators in designing and implementing the detailed and technical requirements that will apply to firms;

d. a flexible and proportionate approach, enabling the UK to both maintain a strong future partnership with the EU and other major economies, and to account for specificities in the UK financial services market.

Delegation and accountability framework

1.14 HM Treasury considers the most effective way to balance the principles in 1.13 is to delegate responsibility for the implementation of firm requirements to the Regulators, subject to an enhanced accountability framework. This means that the vast majority of the updated banking regime will be implemented in PRA rules, and the vast majority of the IFPR will be implemented in FCA rules.

1.15 This accountability framework will enable greater scrutiny of the Regulators' decision-making by enhancing transparency for Parliament, industry and the public.

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[1] See HM Treasury policy statement of 11th March: *Prudential standards in the Financial Services Bill*.

This is in line with the points raised by the House of Lords EU Financial Affairs sub-committee on 27 March[2], who recommended that the government should delegate more powers to the Regulators to give the UK's regulatory regime more flexibility and increase its ability to respond to changes, and that these changes should be supported by strengthened Parliamentary scrutiny.

1.16 To achieve this, HM Treasury will legislate to create additional requirements for the Regulators to consider specifically when using their rule-making powers to introduce and maintain these regimes. These additional requirements are intended to be specified at the level of regulatory principles or equivalent. The PRA's primary and secondary objectives, and the FCA's strategic and operational objectives, will therefore keep the same status as they currently have.

1.17 The accountability framework will include additional requirements to ensure that the wider objectives of the government and Parliament are taken into account. This will include the impact of regulatory requirements on UK competitiveness, international developments in prudential regulation (including international standards, where applicable), and our relationships with other jurisdictions, such as financial services equivalence.

1.18 For the implementation of updated prudential rules for banks (Basel implementation), the PRA will also need to ensure that the impact on sustainable lending to the UK economy is sufficiently considered.

1.19 HM Treasury also intends to include additional detail in the legislation which will specify the IFPR's ultimate objectives. This additional detail will prescribe that the new regime should address the potential harm that investment firms pose to their clients, the risks they may pose to markets and should capture, where relevant, the specific vulnerabilities and risks inherent to investment firms.

1.20 When consulting on rules, the Regulators will be required to set out how these new requirements have been taken into account, balanced and traded-off. This will ensure greater visibility for industry, consumers and Parliamentarians of the Regulators' decision-making process when designing the regime and allow for a more robust consultation to take place. Once the rules are finalised, the Regulators will also be required to explain how these new rule-making requirements have influenced the design of the regime.

1.21 The Regulators will be bound by this new accountability framework when making rules to introduce and maintain these new regimes. In respect of all their other functions, the Regulators will continue to be bound by the same requirements as they are now.

1.22 The legislative approach explained above meets the immediate challenge of ensuring the UK maintains a world-leading prudential regime consistent with recent developments in international standards. Over the longer term, the government is reviewing the overall framework for financial services regulation in the UK, to determine how the framework needs to adapt to the UK's new position outside of

[2] See House of Lords EU Financial Affairs sub-committee letter to the Chancellor of the Exchequer, 27 March 2020.

the EU, and to ensure the framework is fit for the future. The review will explore how the UK's expert, independent Regulators can take the lead on designing and implementing the specific requirements that apply to firms, while ensuring there is appropriate democratic policy input. This includes considering what the role of government and Parliament should be in deciding how important public policy issues are to be addressed in key areas of financial services regulation.

Changes to existing legislation to enable the implementation of the new regimes

CRRII and Basel 3.1

1.23 To enable the Regulators to make rules on these prudential standards, the FS Bill will:

a. delete articles of the retained CRR where appropriate to do so;

b. provide HM Treasury with a power to delete further elements of CRR using secondary legislation where additional flexibility may be required. For example, with regards to Basel 3.1.

Investment Firms Prudential Regime

1.24 Similarly, HM Treasury also intends to make a number of other amendments to the statute book, including:

a. amending retained CRR to disapply it for FCA-regulated investment firms;

b. amending retained MIFIR to update the equivalence provisions for third country investment firms under Title VIII.

Timings of introduction

1.25 The government recognises that UK credit institutions and investment firms may have been preparing for the introduction of the EU's CRRII and IFR/IFD. The government also recognises the potential impact on competitiveness of an untimely introduction of new prudential standards.

1.26 Therefore, the UK will endeavour to introduce the IFPR and updated prudential standards for credit institutions (those contained in CRR2 for the EU) by Summer 2021, broadly consistent with the applicability date of the European Union's IFR/IFD and CRRII. However, as the frameworks for both IFPR and the updated prudential standards for credit institutions are being introduced through the FS Bill, the specific timing of introduction of these regimes will be dependent on the Bill's passage through Parliament.[3]

1.27 Separately, on 27 March, the BCBS announced a one-year delay to the implementation of the Basel 3.1 standards. This will provide operational capacity for banks and supervisors to respond to the immediate financial stability priorities emerging from the impact of Covid-19. HM Treasury remains committed to the full, timely and consistent implementation of the Basel 3.1 standards and we will work

[3] The UK's transposition of CRDV will be consulted on over Summer.

together towards a UK implementation timetable that is consistent with the one-year delay.

Chapter 2
A prudential regime fit for the UK

1.28 This chapter details HM Treasury's policy approach when legislating to enable the Regulators to introduce updated standards for credit institutions and the IFPR; these will account for the specifics of the UK industry. It describes the areas where HM Treasury intends to legislate a different approach to the EU in the FS Bill.

1.29 With the legislative approach described in Chapter 1, much of the detailed implementation of the regimes will be for the Regulators to consult on. The Regulators will therefore set out further detail regarding how they intend to tailor these prudential regimes to the UK in due course.

1.30 This chapter does not set out how the UK will tailor Basel 3.1, given the delayed implementation deadline to 1 January 2023.

UK policy approach

1.31 The UK played an instrumental role in the introduction of IFR/IFD and CRRII at EU level, negotiated them as a Member State, and is supportive of their respective intended outcomes.

1.32 To minimise uncertainty and in recognition of the timing constraints described in 1.25, the government and the Regulators propose to introduce the IFPR and updated rules for credit institutions such that they achieve similar intended outcomes as those in IFR/IFD and CRRII respectively. The government and Regulators will implement targeted deviations from the EU regimes where they are necessary to reflect:

a. the number, size and nature of investment firms and credit institutions within the UK;

b. the structure of the UK market and how it operates.

1.33 In the context of the legislative approach proposed, HM Treasury and the Regulators have not as yet identified aspects of CRRII which, in order to tailor to the UK, would require legislation. As noted in 1.29, the PRA will set out further detail on how they will tailor the regime to the UK in due course.

1.34 When legislating for the IFPR, HM Treasury has identified one targeted deviation from the EU's IFR/IFD within its legislative remit, as set out below.

1.35 HM Treasury's approach to the IFPR should be read in conjunction with the FCA's upcoming discussion paper. This paper will provide an opportunity to discuss how the FCA may tailor the EU's IFR/IFD to the UK, when making rules for the IFPR.

IFPR: Approach to the re-authorisation of systemic investment firms

1.36 This section outlines HM Treasury's specific policy approach regarding a targeted deviation to the EU's IFR/IFD when legislating for the UK's IFPR.

1.37 The IFR requires systemic investment firms – that is investment firms which by their size, activities and interconnectedness with the rest of the financial system are considered to pose a risk to the stability of financial markets – to re-authorise as non-deposit taking credit institutions.

1.38 The EU regime recognises that these firms present risks which are similar to those posed by large credit institutions and as such should be supervised by their relevant banking authority. For Banking Union members, that is the Single Supervisory Mechanism. This approach is appropriate to allow for consistent supervision of systemic cross-border wholesale activities across the European Union. The re-authorisation becomes the tool required for a smooth transition between competent authorities.

UK approach

1.39 At present, the PRA is the relevant supervisor of systemic investment firms and credit institutions in the UK. UK systemic investment firms are already prudentially regulated and supervised under CRR/CRD by the UK banking authority through a designation procedure exercised by the PRA. This will remain the case after the implementation of the IFPR. Therefore, HM Treasury and the PRA do not intend to require such firms, which will be PRA-designated investment firms, to apply for authorisation as credit institutions.

1.40 HM Treasury and the Regulators consider that the existing PRA designation framework achieves the same outcomes sought by the EU's IFR. Therefore, this is sufficient to identify and allocate those firms which will be prudentially regulated under the banking rules (the CRR/CRD) – under the PRA's regulatory and supervisory remit – and those which will be prudentially regulated under the IFPR – under the FCA's regulatory and supervisory remit.

Related announcements

1.41 As announced in HM Treasury's Budget policy statement, it is the intention of the government and the PRA to transpose CRDV by 28 December 2020, in line with commitments under the EU Withdrawal Agreement.

1.42 It is HM Treasury's intention that CRRII/CRDV and any subsequent updates to the banking regime should not apply to FCA-regulated investment firms, who should continue to comply with the relevant current regulation until the IFPR is in place. HM Treasury intends to make the necessary legal clarifications through transposition.

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