HM Treasury

Implementation of the Investment Firms Prudential Regime and Basel 3 standards

Consultation response

June 2021

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Chapter 1

Introduction

1.1 The Government launched a consultation on 4 February 2021 entitled 'Implementation of the Investment Firms Prudential Regime and Basel 3 Standards'. The consultation document outlined how the Government proposes to exercise powers under what is now the Financial Services Act 2021 (FS Act)[1] to ensure the effective implementation of the Investment Firms Prudential Regime (IFPR) and the outstanding Basel 3 standards. The consultation closed on 1 April 2021.

1.2 The Government, the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) announced their intention to target an implementation date of 1 January 2022 for the new IFPR regime and the outstanding Basel 3 standards. The FCA is consulting on the IFPR in a staggered manner, with the first consultation undertaken between 14 December 2020 and 5 February 2021[2] and the second consultation between 19 April 2021 and 31 May 2021[3]. The PRA consulted on the key elements of the updated Basel 3 regime, and its consultation closed on 3 May 2021[4].

1.3 The Government's consultation sought comment on the areas where it is proposing to legislate, which include:

- the revocation of sections of the UK Capital Requirement Regulation (CRR) to be replaced by the PRA's rules, which will implement the updated requirements;
- the equivalence regime for exposures to units or shares of a Collective Investment Undertaking (CIU); and
- disallowing Globally Systemically Important Institutions (G-SIIs) from including eligible liabilities, issued by one of their subsidiaries, to meet their Total Loss Absorbing Capacity (TLAC) requirements;
- the implementation of reporting requirements for the final set of Basel updates to the Fundamental Review of the Trading Book (FRTB) Standardised Approach (SA);
- amendments required to ensure the macroprudential framework, in relation to the FPC's powers of direction, is consistent with the updated prudential regime for banks, following the passing of the FS Act and associated secondary legislation;

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1 Financial Services Act 2021

2 CP20/24: A new UK prudential regime for MiFID investment firms

3 CP21/7 A new UK prudential regime for MiFID investment firms

4 CP5/21 - Implementation of Basel standards

- definitions regarding the entities within a group structure to whom the FCA's IFPR rules may apply on a consolidated basis;
- consequential changes to legislation, in particular to the Financial Services and Markets Act 2000 (PRA-regulated Activities) Order 2013 (PRA RAO)[5], as a result of changes to the level of initial minimum capital for investment firms, which will be set in FCA rules; and
- the applicability of the UK resolution regime in Part 1 of the Banking Act 2009[6] to FCA investment firms.

1.4 The Government received 12 responses (see Annex A for a list of respondents). This document gives a summary of the responses received and gives the Government's response to them, as well as explaining the next steps where necessary.

5 The Financial Services and Markets Act 2000 (PRA-regulated Activities) Order 2013

6 Banking Act 2009

Chapter 2

Implementing the Basel 3 standards: Exercise of the Clause 3 revocation power

2.1 Responses noted support for the approach of detailed prudential rules being made by the PRA. The Government did not receive any substantive responses on the exercise of the Clause 3 revocation power. The Government intends to lay the secondary legislation required to revoke the specific provisions in the UK CRR shortly (except in relation to leverage), and to pass a second Statutory Instrument (SI) - before the end of the year - which makes amendments to legislation which are needed as a consequence of these revocations, and revokes provisions relating to leverage.

Question 1: Do you have any comments on the value of keeping this equivalence provision in Article 132 of the UK CRR?

2.2 Article 132 of the UK CRR relates to the capital treatment of exposures that banks have in units/shares of a CIU. As set out in the Government's consultation document, the EU's CRR2 implements the latest Basel reforms for these investments, which includes a default 1250% risk-weight for funds where the institution cannot use one of two options to determine risk-weights based on information available about the underlying funds (the 'look-through' and 'mandate-based' approaches).

2.3 The EU's 2nd Capital Requirements Regulation (CRR2) also removes the existing equivalence regime in Article 132 of the CRR – which allows for a standalone equivalence assessment specifically for this Article. Instead it attaches equivalence to the provision of the third-country passport contained in the Alternative Investment Fund Managers Directive (AIFMD) (i.e. if a third-country has been granted access via the AIFMD third-country passport, they are also deemed equivalent for Article 132 of the CRR).

2.4 The Government consulted on its intention to maintain the equivalence provision in Article 132 of the UK CRR, while revoking the remainder of the Article and thereby allowing the PRA to make rules in this area. This was designed to provide a balance between openness and prudential soundness. The Government could make determinations under Article 132 of the UK CRR independently (e.g. rather than linking the provision to the third country passport contained in the AIFMD) whilst having an equivalence regime which was deemed to be of value to the UK Authorities in managing and mitigating prudential risk.

2.5 The Government received 4 responses to this question. There was a consistent request to remove the need for an equivalence provision in this area on the grounds that it is unnecessary and not required by the Basel 3 standards. Respondents were also of the view that there could be a risk of cliff edge impacts - where banks try to alleviate significantly higher risk weighted assets (RWAs) by offloading investments in funds in a number of jurisdictions - if equivalence determinations were not made by 1 January 2022.

2.6 Following these responses, having reviewed the costs and prudential benefits of its approach to Article 132 – and after considering the views of the PRA and the FCA - the Government now considers that applying the equivalence provision would be a disproportionate method for addressing the prudential risks arising from UK banks' investments in overseas funds. The Government has therefore decided to remove the equivalence provision contained in Article 132 of the UK CRR. The PRA could address any risks which arise as a result of a firm's exposure to funds located and managed in overseas jurisdictions.

2.7 No responses were received to the specific area of Minimum Requirements and Eligible Liabilities (MREL) policy discussed in this Chapter. Responses were received raising issues with the Government's approach to other aspects of resolution policy. These issues are discussed in Chapter 5.

Chapter 3

Fundamental Review of the Trading Book

Question 2 and 3: Do you have any comments on the Government's proposed timeline for the implementation of these regulations?

The EU Commission adopted the delegated act referred to above on 17 December 2019. Do you have any comments on the form these regulations should take in the UK?

3.1 The Government received six responses to this Chapter. These responses covered a wide range of issues with the scope, timing and specific policy of FRTB SA reporting requirements, as well as requests to not implement these reporting requirements ahead of the FRTB SA capital requirements (i.e. not to implement this as a standalone reporting requirement only).

3.2 Respondents noted that the implementation of the FRTB SA reporting requirements, ahead of the FRTB capital requirements, is not mandated by the Basel 3 standards. In addition, respondents stated that sequencing implementation in this way would have material costs to business.

3.3 In light of the new evidence provided, and having consulted the PRA, the Government considers these concerns to be valid. As a result, the FRTB SA reporting requirements will be implemented alongside any changes to FRTB revisions to Pillar 1 capital requirements (i.e. as part of Basel 3.1 and not from 1 January 2022).

Chapter 4

Amendments to ensure the macro-prudential framework is consistent with the new regime

4.1 The Government's consultation also set out its intention to ensure the macro-prudential framework appropriately reflect the enactment of the FS Act. In line with this approach, the Government recently laid draft legislation which, among other amendments[1], aims to ensure:

- all macro-prudential measures can be applied to holding companies that are approved or designated by the PRA; and
- within the order setting out the FPC's powers of direction over the leverage ratio, the "total exposure measure" will be defined by reference to PRA rules. Reflecting this change, the FPC will be able to make specifications over how the total exposure measure is defined for the purpose of implementing a macro-prudential measure.

4.2 The Government will make further consequential amendments in due course to complete this work.

[1] Draft legislation here.

Chapter 5

Additional Basel responses

Basel 3 implementation

5.1 In addition to the matters included in this consultation, the Government also received requests for changes to other areas of Basel 3 implementation. The majority of these relate to areas where the PRA has proposed to make rules as part of its consultation paper 'Implementation of Basel Standards' (CP5/21). These areas include:

- the Net Stable Funding Ratio (NSFR);
- the Standardised Approach to Counterparty Credit Risk (SA-CCR);
- the Large Exposures Framework; and
- reporting and disclosure requirements.

5.2 As with other matters of Basel 3 that are covered by the PRA's consultation, these matters are for the PRA to consider in line with its statutory safety and soundness and competition objectives, and the matters to which the PRA is required to have regard, including those introduced under the FS Act 2021.

5.3 The PRA's consultation closed on 3 May 2021 and it will respond to points raised as part of that consultation, including where they relate to the above areas, in due course.

5.4 Additional clarity was also sought on two matters for which the Government retains responsibility. These matters are set out below.

Article 391 CRR equivalence

5.5 Respondents queried how the equivalence determination for the purposes of Large Exposures will work under Article 391 of the UK CRR.

5.6 Under Article 391 of the UK CRR, the Government may by regulations determine that an overseas jurisdiction applies prudential and regulatory requirements at least equivalent to those applied in the UK. The effect of these regulations is that the Large Exposures limits in Article 395(1) of the UK CRR that apply to exposures to institutions authorised in such an overseas jurisdiction are the same as the limits that apply to exposures to institutions in the UK.

5.7 The UK's only equivalence determination in this area is with respect to European Economic Area States. Prior to Implementation Period Completion

Day (IPCD) the European Banking Authority had issued guidance to apply the treatment provided for under Article 391 to institutions authorised in countries found equivalent under other articles in the Capital Requirements Regulation.

5.8 To continue this effect post-IPCD, the Government would need to carry out a large number of assessments (with support from the PRA under the terms of the equivalence MOU) and make corresponding equivalence determinations by regulations under Article 391 of the UK CRR. Completing these assessments quickly will not be possible, therefore, the Government will seek to put in place transitional arrangements to maintain the effect of the pre-existing treatment that was in place under the EU arrangements.

5.9 In parallel, given that the equivalence assessment carried out under Article 391 of the UK CRR is identical to that under Article 107 of the UK CRR, the Government will seek a legislative opportunity to streamline the approach by providing for the current effect of an equivalence decision under Article 391 of the UK CRR to be conferred under Article 107 of the UK CRR.

5.10 The transitional arrangement will end in relation to an overseas jurisdiction either:

a) when an equivalence determination is made by the Government under Article 391 of the UK CRR in relation to that overseas jurisdiction; or
b) when the transitional is ineffective because Article 391 of the UK CRR has been amended.

5.11 The intended effect of this approach is to provide continuity for firms on the scope and definition of an institution for Large Exposures purposes.

Resolution Policy

5.12 The Government also received responses on areas relating to the UK's resolution regime. Whilst these responses are out of scope of this consultation, the Government thanks the respondents and provides a brief overview of its approach to the relevant provisions below.

5.13 The Government received a recommendation that 'Operational Deposits' should be excluded from 'bail-in' and 'resolution stays', under the Banking Act 2009. The Government would like to note that there are already certain categories of Operational Deposits which are excluded from bail-in. The Bank of England ('the Bank'), as the UK's resolution authority, also has the discretion to exclude, under Section 48B of the Banking Act 2009, a liability or class of liabilities, including Operational Deposits, from bail-in on any one of a number of grounds, including that the exclusion is necessary and proportionate to achieve continuity of the relevant bank's critical functions and core business lines. In the case of temporary resolution stays, there are also exceptions for 'eligible claims', 'eligible deposits' and payments to 'excluded persons'. The Government would also like to note that under Section 70A of the Banking Act 2009:

- the exercise of the temporary suspension or moratorium power is entirely discretionary on the part of the Bank;

- the power is exercised only in relation to a contract or contracts identified by the Bank in the relevant instrument issued by the Bank in exercise of stabilisation powers – not in relation to all contracts of the firm in resolution unless so specified;
- the Bank must have regard to the potential impact of a suspension on the orderly functioning of the financial markets before exercising the power; and
- the suspension cannot last for more than 48 hours.

5.14 The Government hopes that the above provides clarity on the scope of the use of bail-in and resolution stays.

5.15 The Government also received a response relating to the scaling of TLAC. The response requests that for institutions that are material subsidiaries of non-UK G-SIIs, internal TLAC be set between 75-90% of external TLAC requirements instead of the current 90%. While this response is out of scope of the consultation, the Government is considering this issue separately.

Chapter 6

Exercise of powers 143B(2) FSMA: Definitions in Part 9C

6.1 The Government received one response to this section. The focus of the response centred around the Government's intention to replicate the scope of prudential consolidation under the CRR in the definition of 'group' in FSMA. The response claimed that this would impose inappropriate consolidated supervision requirements for certain UK firms.

6.2 The Government, which considered the issues raised alongside the FCA, sees no reason to depart from its intention to replicate the scope of prudential consolidation that applies under Article 18 of the UK CRR.

6.3 The two primary issues were about how the concepts of 'significant influence' and 'single management' could raise issues on the scope of consolidation where an investment is made in a regulated entity.

6.4 In its Policy Statement (in response to CP20/24), to be published at the end of June 2021, the FCA has updated its guidance provisions on the meaning of 'significant influence'. The Government directs readers to those near-final rules and, in particular, the updated guidance in MIFIDPRU 2.4.11G. This provides a clearer basis on which firms can carry out an assessment of 'significant influence', based on accounting standards.

6.5 Regarding the concept of 'single management', the FCA has informed the Government that firms should refer to its near-final position stated in MIFIDPRU 2.4.14G. The indicators of 'single management' provided in MIFIDPRU 2.4.14G are not conclusive. Instead, firms should look to determine whether, in practice, there is effective coordination between the financial and operating policies of the firm and the portfolio company in question. Firms should look at all relevant facts and circumstances for these purposes. The indicators provided may be evidence of effective coordination, but do not automatically mean that such coordination exists in every case. For instance, where a firm has appointed a limited number of directors to the board of a portfolio company to protect the financial interests of its managed funds, the FCA has confirmed its view that this is unlikely, in and of itself, to qualify as effective coordination.

Chapter 7

Consequential amendments to the PRA RAO reflecting new initial capital levels for investment firms

7.1 The Government received two responses to this section. One of the responses was supportive of the proposed approach. The other response expressed concern about the PRA designating all investment firms as authorised to deal as principal, which would result in disproportionate capital requirements for these investment firms.

7.2 The Government sees no reason to depart from its proposed approach of amending the Financial Services and Markets Act (PRA-Regulated Activities) Order 2013 ("PRA RAO"), to remove reference to the EUR 730,000 Initial Capital Requirement (ICR), which will become obsolete.

7.3 This will allow the PRA to designate investment firms that deal as principal under Part 4A of FSMA where it considers this is desirable. To do so, the PRA will need to have regard to its statutory objectives, the assets of the person or group and its statement of policy on the designation of investment firms[1].

7.4 There are currently 8 investment firms that the PRA has designated – all of which have been designated since the PRA designation regime was established in 2013. The remaining around 500 investment firms that deal as principal are regulated by the FCA. The proposed amendment by the Government will not, in of itself, designate these firms for prudential supervision by the PRA.

[1] *Statement of Policy: Designation of investment firms for prudential supervision by the Prudential Regulation Authority*, Prudential Regulation Authority, March 2013

Chapter 8

Application of the UK resolution regime to FCA investment firms

8.1 The changes to the EUR 730,000 ICR require, among other things, consequential changes to the Banking Act 2009 (Exclusion of Investment Firms of a Specified Description) Order 2014[1], which relate to resolution. The changes to legislation that will be made as a result of the IFPR, including changes to ICR levels, present an opportunity to consider the scope of the UK resolution regime in relation to investment firms regulated by the FCA (FCA investment firms).

8.2 Firms subject to the UK resolution regime are banks, building societies and some investment firms. Specifically, investment firms with an EUR 730,000 ICR are subject to the UK resolution regime.

8.3 The requirements firms are subject to depend on their resolution strategy. Each year, the Bank is required to review its preferred resolution strategy for firms in scope of the resolution regime. Currently, the Bank's preferred resolution strategy for all FCA investment firms with an EUR 730,000 ICR is insolvency (i.e. no exercise of stabilisation powers). As a result, these FCA investment firms have not been subject to the requirements of the Resolvability Assessment Framework, or MREL requirements, above their own funds requirements.

8.4 The Government consulted on the scope of the UK resolution regime in relation to FCA investment firms. The Government received six written responses to this section. These responses are summarised below.

Question 7: Do you have any comments on the scope of application of the UK resolution regime in relation to FCA investment firms?

8.5 All six respondents were of the view that FCA regulated investment firms should not be in scope of the UK resolution regime. Five respondents highlighted that these firms are not systemic and that the Bank's preferred resolution strategy for these firms is insolvency. They also indicated that the FCA should have primary responsibility for the orderly failure of FCA solo-regulated investment firms.

8.6 One firm noted that if GBP 750,000 firms were brought into scope, which in their view would not be preferable, exemptions and simplified obligations similar to the current ones available for EUR 730,000 firms should be continued.

[1] S.I. 2014/1832

8.7 Three respondents noted that firms already have to undertake wind-down planning, which is sufficient to ensure orderly failure at any point in time. Four respondents also highlighted that the PRA has designation powers to bring firms that they assess as systemic in scope of the resolution regime.

8.8 One respondent observed that scoping out FCA investment firms would align with international standards, pointing out the Financial Stability Board's Key Attributes refer to systemic firms and banks only. One firm maintained that extending the resolution regime to GBP 750,000 investment firms risks extending disproportionate capital requirements for investment firms, leading to the withdrawal of liquidity from London's financial markets.

Question 8 and 9: For FCA investment firms currently in scope of the UK resolution regime: please share any relevant data and information on how the UK resolution regime impacts upon your operations. For other FCA investment firms not currently in scope of the UK resolution regime: please share any relevant data and information related to your assessment of the potential impact of being subject to the UK resolution regime, if its scope of application was expanded as a result of the changes to ICR levels that the FCA is consulting on.

8.9 One respondent, whose members are in scope of the UK resolution regime, noted that significant resource and effort is required to monitor and update the recovery plan requirements each year, as well as the resolution pack every other year.

8.10 One respondent, that is not in scope of the resolution regime due to the exemptions currently in place, noted that there are overlaps between wind-down planning and the recovery and resolution regime requirements set out in IFPRU 11[2]. The respondent said that the recovery and resolution regime is more onerous.

Government response

8.11 The Government, having consulted with the Bank, the PRA and the FCA, and taking into account consultation responses, has decided to remove FCA-regulated EUR 730,000 ICR firms from the scope of the UK resolution regime. Additional firms brought into the scope of the GBP 750,000 capital requirement will also not be within scope of the UK resolution regime. PRA-designated investment firms will continue to remain in scope of the UK resolution regime.

8.12 FCA investment firms will remain subject to relevant legislation and the FCA's existing rules and processes in place to facilitate the orderly wind-down of FCA investment firms. In addition, the Investment Bank Special Administration Regime (IBSAR) will be available to use to manage the failure

2 IFPRU 11

of some investment firms[3]. The FCA is in the process of consulting on the introduction of the IFPR. This includes new rules and guidance around wind-down planning, which was covered in the FCA's second consultation CP21/7[4].

8.13 In reaching this decision, the Government has considered the potential impact if an FCA investment firm or firms were to fail, the impact for these firms of remaining in scope of the resolution regime and the existing tools and processes that are available to manage the failure of FCA investment firms. The Government views the existing rules, supervision and tool kit that the FCA has in place (or will put in place through the IFPR), which are designed to ensure an orderly wind-down of these firms, as well as, the IBSAR, as the more appropriate tools for these firms. The IBSAR is a bespoke insolvency regime designed to provide an insolvency practitioner with specific tools to achieve better outcomes for consumers and markets in the event of an investment firm failure, in particular by prioritising the return of client assets.

8.14 We also consider this approach to be in line with the wider IFPR rationale, to introduce proportionate prudential requirements for investment firms. If an FCA investment firm becomes systemic, the PRA has the power to designate it, if it considers it desirable to do so, based on the relevant considerations noted in the PRA's Statement of Policy on 'the designation of investment firms for prudential supervision by the PRA'[5]. This would have the effect of bringing the firm into scope of the UK resolution regime.

Next Steps

8.15 The changes to the scope of the resolution regime will require changes to the legislation underpinning the UK resolution regime. The Government intends to deliver this via secondary legislation later in 2021.

8.16 The FCA will publish its third IFPR consultation, and related policy statements, later this year.

[3] IBSAR will only be available to use for investment firms that meet the definition of 'investment bank' in section 232 of the Banking Act 2009

[4] See first consultation CP20/24 and second consultation CP21/7 issued earlier this year.

[5] Statement of Policy - Designation of investment firms for prudential supervision by the PRA

Annex A
List of respondents

BNY Mellon

BVCA

Duff & Phelps

FIA EPTA

HSBC

ICE

IHS Markit

ISDA/AFME joint response

PIMFA

Quilter plc

Standard Chartered

UK Finance

HM Treasury contacts

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