PARLIAMENTARY DEBATES

HOUSE OF COMMONS
OFFICIAL REPORT

Fifth Delegated Legislation Committee

DRAFT CAPITAL REQUIREMENTS (AMENDMENT) (EU EXIT) REGULATIONS 2018

DRAFT BANK RECOVERY AND RESOLUTION AND MISCELLANEOUS PROVISIONS (AMENDMENT) (EU EXIT) REGULATIONS 2018

Wednesday 12 December 2018

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The Committee consisted of the following Members:

Chair: Ms Karen Buck

† Bacon, Mr Richard *(South Norfolk)* (Con)
Burden, Richard *(Birmingham, Northfield)* (Lab)
Campbell, Mr Ronnie *(Blyth Valley)* (Lab)
† Champion, Sarah *(Rotherham)* (Lab)
† Debbonaire, Thangam *(Bristol West)* (Lab)
† Dunne, Mr Philip *(Ludlow)* (Con)
† Foster, Kevin *(Torbay)* (Con)
† Glen, John *(Economic Secretary to the Treasury)*
† Heald, Sir Oliver *(North East Hertfordshire)* (Con)
† Lewer, Andrew *(Northampton South)* (Con)
† Merriman, Huw *(Bexhill and Battle)* (Con)
† Reynolds, Jonathan *(Stalybridge and Hyde)* (Lab/Co-op)
† Stevens, Jo *(Cardiff Central)* (Lab)
† Thewliss, Alison *(Glasgow Central)* (SNP)
† Villiers, Theresa *(Chipping Barnet)* (Con)
† Walker, Thelma *(Colne Valley)* (Lab)
† Whittaker, Craig *(Lord Commissioner of Her Majesty's Treasury)*

Sarah Rees, *Committee Clerk*

† attended the Committee

Fifth Delegated Legislation Committee

Wednesday 12 December 2018

[MS KAREN BUCK *in the Chair*]

Draft Capital Requirements (Amendment) (EU Exit) Regulations 2018

8.55 am

The Economic Secretary to the Treasury (John Glen): I beg to move,

That the Committee has considered the draft Capital Requirements (Amendment) (EU Exit) Regulations 2018.

The Chair: With this it will be convenient to consider the draft Bank Recovery and Resolution and Miscellaneous Provisions (Amendment) (EU Exit) Regulations 2018.

John Glen: It is a pleasure to serve under your chairmanship, Ms Buck. As has been said before, Her Majesty's Treasury, as part of preparations for the UK's withdrawal from the EU, is laying statutory instruments under the European Union (Withdrawal) Act 2018 to ensure that there continues to be a functioning legislative and regulatory regime for financial services in the UK in the event of a no-deal scenario. That includes the two SIs we are debating today, which will fix deficiencies in UK law relating to the UK's prudential regime for credit institutions and for bank resolution. As with other SIs that the Treasury has laid and debated under the 2018 Act, they are designed to provide continuity at the point of exit by maintaining existing legislation, but amending it where necessary to ensure that it works effectively in a no-deal context.

The first SI being considered today concerns the prudential rules that apply to banks, investment firms and building societies under the framework set by the EU capital requirements regulation and capital requirements directive. The second SI relates to the bank recovery and resolution directive, which sets out requirements for ensuring that bank failures can be managed in an orderly way and provides a common EU framework for firm resolution. In a no-deal scenario, the UK would be outside the European economic area and the EU financial services framework. The SIs will make amendments to retained EU law so that the legislation would continue to function effectively in a no-deal scenario.

The draft capital requirements regulations will make amendments to the retained EU capital requirements regulation and the domestic secondary legislation that implemented the EU capital requirements directive. The draft regulations will make the following principal amendments. First, they will make changes to the group consolidation regime for liquidity and capital. Current EU legislation allows EU banking groups to report a single set of figures for their activities across the EU. The SI will amend those requirements, so that they operate at UK level only. That will not affect the application of consolidated capital requirements, which are already calculated and reported on a national basis, but it will introduce an additional layer of liquidity consolidation in the UK, as liquidity is currently consolidated at EU level.

Secondly, the draft capital requirements regulations will remove the preferential capital treatment available for exposures to certain EU institutions and assets, including sovereign debt. For example, the EU capital requirements regulation does not require firms to hold capital for EU sovereign debt, because it rates those exposures with a zero risk weighting. That is to incentivise investment in certain EU asset classes. In line with our general approach, we will not grant the EU unilateral preferential treatment in the absence of an assessment of equivalence after exit day. We would therefore not automatically continue with the regime of preferential capital treatment for EU assets.

The draft capital requirements regulations will also remove the requirement for UK regulators to seek approval from EU institutions for the use of macroprudential tools to deal with systemic risk, including action that may need to be taken in a financial crisis.

Sir Oliver Heald (North East Hertfordshire) (Con): My understanding is that during the implementation period, we will continue to take the EU laws in this area, so the CRR will be part of our law anyway, and we will look to maintain that position until we reach a new agreement. Is the Minister saying that if we had a no-deal exit, we would do something different and we would not want to retain the position in that way while we negotiated a Canada deal or something of that sort?

John Glen: I am grateful for my right hon. and learned Friend's intervention. What we would do in a no-deal scenario in respect of CRR II, which is in flight at the moment within the EU, would be to use the Financial Services (Implementation of Legislation) Bill, which came before the House of Lords last week and will hopefully come to the Commons at some point in late January. That would give us discretion on how or whether to implement the file that would then land after our exit from the EU, or part of that file, based on what makes sense for the UK economy. We have listed in that Bill all in-flight files, and we would make a decision on the suitability of its inclusion in UK law at a future point following our exit.

To conclude on the first SI, removing the requirement to seek approval from EU institutions is necessary so that UK regulators are able to continue to exercise the macroprudential functions that Parliament has given them. Effective exercise of those functions is essential to maintaining the stability of the UK financial system.

Moving on to the second statutory instrument, the bank recovery and resolution SI will amend the Banking Act 2009 and related domestic and retained EU legislation, with the following principal amendments. First, the draft regulations will amend the scope of the UK's third-country resolution recognition framework to include EEA-led resolutions. This will ensure that in a no-deal scenario, the same approach will be followed for EEA countries and other third countries in recognising third-country resolution actions. We have that arrangement now with the USA, for example, and we would have to treat EU countries in the same way, or similarly. The

UK's approach to recognising third-country resolution actions has been and will continue to be consistent with our G20 commitments.

The refusal of the UK to recognise a third-country resolution action is only permitted where the Bank of England and the Treasury are satisfied that one or more statutory grounds for refusal exist. Those grounds are: first, that recognition would have an adverse effect on UK financial stability; secondly, that it is necessary for the Bank of England to achieve one or more of its special resolution objectives; thirdly, that a third-country resolution action treats UK creditors less favourably; fourthly, that recognition would have material fiscal implications for the UK; or fifthly, that recognition would be unlawful under the Human Rights Act 1998.

Secondly, the bank recovery and resolution SI will remove deficient references that require UK regulators to follow the specific operational and procedural mechanisms set out in the bank recovery and resolution directive to co-operate with EEA authorities. The removal of these references will not, however, prevent UK regulators from choosing to co-operate with their EEA counterparts after exit. UK regulators will remain able to share information with EEA authorities in the same way that they currently do with authorities in third countries, such as the United States. Additionally, the UK will continue to participate in international crisis management groups, which enhance co-operation between home and host authorities of systemically important banks. Finally, the draft regulations address deficient cross-references to the bank recovery and resolution directive in UK legislation, and ensure that delegated regulations retained by the European Union (Withdrawal) Act continue to be workable following exit.

In line with the approach the Government are taking across all files laid under the European Union (Withdrawal) Act, both SIs transfer a number of functions currently within the remit of EU authorities, in particular the European Banking Authority and the European Securities and Markets Authority, to the relevant UK bodies. Those functions, such as the development of detailed technical rules on certain provisions of the regulations, will now be carried out by appropriate UK authorities, namely the Financial Conduct Authority, the Prudential Regulation Authority or the Bank of England. This is appropriate, given the regulators' expertise in prudential and resolution policy and in the supervision of global firms. The regulators are currently undertaking public consultations on the changes they propose to make to binding technical standards. The SIs further confer regulation-making powers on the Treasury to replace delegated powers that were previously conferred on the European Commission, in line with the approach taken across other Treasury legislation.

To summarise, the Government believe that both SIs are needed to ensure that the regulatory regime applying to banks, building societies and investment firms works effectively if the UK leaves the EU without a deal or an implementation period. I hope that colleagues across the Committee will join me in supporting the regulations, which I commend to the Committee.

9.5 am

Jonathan Reynolds (Stalybridge and Hyde) (Lab/Co-op): It really is a pleasure, Ms Buck, to serve under your chairmanship. Once again, the Minister and I find ourselves in this room, as we work through the list of dozens of Treasury statutory instruments that are needed as we prepare for EU withdrawal. It is nice to see that there is a crowd this morning—there must be something else going on today, perhaps later on.

On each of these occasions, I and my Front-Bench colleagues have spelled out our objections to secondary legislation being used in this manner, as well as the challenges of ensuring that there is proper scrutiny, given the sheer volume of legislation passing through these Committees. All of this legislation is speculative, as it prepares us for a UK no-deal exit. It feels surreal to stand here discussing the finer points of financial regulation when the overall process is in total chaos.

It is near inconceivable that we are now so close to exit with no agreement in place and no vote scheduled on any such agreement. That places even greater importance on the work we are doing here, as with every passing day that this chaotic situation is not resolved, we inch closer to crashing out of the EU without a deal. That is a frightening prospect, particularly for financial services and especially for those parts of financial services that cannot operate within an equivalence framework.

Therefore, it is of the utmost importance that the statutory instruments are rigorous in their approach to ensuring the EU financial regulatory framework. The two instruments up for discussion today are of central importance to the stability of our financial system. Both the capital requirements and the recovery and resolution regime were designed to prevent the events of 2008 ever being repeated, given the catastrophic economic consequences. They required considerable co-operation across Europe, supported by wider efforts to comply with new rigorous international standards. Dismantling any element of that regime would be very ill advised, and we do not want to find ourselves in a position where Governments ever have to bail out the banks again.

With that in mind, I will begin by addressing the draft capital requirements instrument. I want to flag a major concern at how this provision is being transposed into UK law, and the potential disadvantage for UK banks. Colleagues will know that the EU capital requirements regulation mandates banks and financial institutions to maintain levels of sufficient quality capital, so that they are more resilient in market downturns or distress and, therefore, less likely to collapse. Different metrics are used to assess the quality of capital, and institutions are required to hold assets in certain ratios to comply with the regulation. It appears that this statutory instrument will remove preferential treatment for EU government debt for UK banks and, therefore, put UK banks holding EU government debt as a capital buffer at a disadvantage, as the Minister confirmed in his opening remarks.

EU member states' government debt is considered very safe by the EU and banks do not need to hold much to meet regulatory requirements. If there is no agreement on equivalence for financial assets, the capital requirements statutory instrument says that UK government debt will no longer be considered so safe by the EU itself and, therefore, the UK Government will respond by removing preferential treatment for EU debt.

The guidance states:

"Once the UK has left the EU, in the absence of an agreement and where no equivalence determination has been made, the EU27 would automatically fall into the category of a third

[Jonathan Reynolds]

country where EU27 exposures would no longer receive preferential capital treatment. Therefore, this SI will remove preferential treatment for EU27 exposures."

On the face of it, that will leave UK banks that hold EU government debt suddenly at a higher risk from a pricing perspective. It will become more expensive for them to hedge their risks in a no-deal environment, where markets are likely to be extremely volatile anyway. Trade publication *GlobalCapital* expresses that simply as a

"hit to UK bank capital ratios at the worst time imaginable".

Where does that leave UK banks with significant EU operations, which are likely to hold this type of debt in large quantities? The Minister has repeatedly assured us that no substantive changes are being made from a policy perspective in the transposition of the rules through statutory instruments, but it seems this risks having a real and negative impact through a decision to change the treatment of EU government debt. Will the Minister please explain how the decision was reached and how it could be remedied to prevent increasing costs for UK banks and the requirement to re-hedge their positions?

The second instrument relates to a framework closely associated with the capital requirements: the recovery and resolution regime. That relates to so-called living wills for financial institutions if they fall into credit-related difficulties. That is another mission-critical strand of post-crisis regulation that continues to evolve.

The Bank of England has announced its plan to bring in a self-assessment regime for UK banks from 2020, which will require them to demonstrate their own winding down and restructuring plans for times of distress, without causing market contagion or requiring a taxpayer bail-out.

The guidance to the bank recovery and resolution statutory instrument states that:

"HM Treasury's approach to onshoring the Bank Recovery and Resolution Directive is to ensure that the UK's Special Resolution Regime is legally and practically workable on a standalone basis once the UK has left the EU."

The challenge is how we can ensure that the recovery and resolution regime continues to be effective while potentially operating in isolation. Realistically, most of the biggest firms in this country are cross-border, so close co-operation will be needed with our EU counterparts to ensure that the risk of contagion is minimised and our approach is consistent. The statutory instrument is very light on detail in that regard. Will the Minister elaborate on the Treasury's role in ensuring that this approach is followed? Is there an existing interaction with a third country or with third-country firms that the Treasury is using as a guide?

The banking framework in the UK has evolved significantly since 2007 to the benefit of both the taxpayer and market stability. Much of that has been achieved through close international co-operation with the EU and G20. We need to make sure that any future framework enshrines that hard work, especially as banks and financial institutions are likely to be highly stressed by market conditions if we crash out without a deal. Sadly, given the chaotic back and forth of the Government this week, the reality is that the prospect of no deal is becoming likelier by the day.

9.11 am

Alison Thewliss (Glasgow Central) (SNP): It is a pleasure to see you in the Chair, Ms Buck.

I want to pick up where my colleague the hon. Member for Stalybridge and Hyde left off. This week, we have lurched closer to the prospect of a no deal Brexit due to the incompetence of the UK Government and Back Benchers who are more interested in feathering their own nests than in the interests of the country as a whole. It is utterly ridiculous for my constituents to see all these shenanigans as the clock ticks and we get ever closer to the point where the UK leaves without a deal.

We have the ridiculous prospect of the Prime Minister touring EU capitals only to find, as was totally predictable and inevitable, that people are not interested in speaking to her—the deal is already done as far as the EU is concerned. All of this is a distraction at a time when we should be focusing on the economy and on those people at the very bottom who are losing out massively as a result of UK Government policies.

We are here today to look at these statutory instruments in further detail, which is hidden away in these Committees rather than being scrutinised in a more open way. It is interesting to look at both instruments and their wider implications such as the familiarisation costs, which I mentioned at a previous SI Committee. The capital requirements regulations will have a total familiarisation cost of £1.7 million, which is absolutely huge. Businesses are being asked to bear those costs as a result of a decision that was not theirs. It will have a huge impact.

The FCA estimates that around 800 businesses will be affected. The Bank of England estimate is 209, so some 1,009 businesses will be affected. I ask the Minister, as I often do, how that is being communicated to those businesses because the clock is ticking, and they need to know and make preparations. The Fraser of Allander Institute mentioned yesterday in its report that small businesses are under-prepared for the prospect of a no-deal Brexit. For a long time, perhaps we hoped that that might not happen, but who knows whether that will remain the case? The Government have a job of work on their hands to ensure that all those businesses are aware of what might happen in the event of a no deal Brexit, and what it will mean for each and every businesses across this country.

The Financial Markets Law Committee is concerned, as I am, about the regulatory burden on the Bank of England, the Prudential Regulation Authority and the Financial Conduct Authority. How will they cope with the additional work coming to them? They are concerned about the recognition in UK law as things progress, withdrawing from the shared protections we have in the EEA and the impact on the market as a whole.

Sir Oliver Heald: Under the withdrawal Act, of course, EU law just comes into our law on the day we leave, but it would be ineffective in this area because there are a lot of references to institutions that we will no longer be in. Does the hon. Lady agree that the regulations are needed?

Alison Thewliss: I do not dispute that they are needed. I am not sure that Brexit is needed, but that is a different argument for a different day. The note mentions that the FCA and PRA will be updating the rule books in time

for exit day. I want to press the Minister a wee bit more about what stage the preparations are at, and whether the expectation is that they will be ready in time. What progress has been made?

As to the capital requirements and, under the CRR, the binding regulations to co-operate and share information with EEA authorities, removing them and moving to a more discretionary system within it obviously means there is a question as to how we maintain the rigour of the system. If it is going to be sharing on a discretionary basis rather than being obliged to do so as part of the system, how will we ensure that things are going to work properly and as well as they can work at the moment? How do we prevent the slide towards another financial crash in a system that is more discretionary rather than one that obliges us to do certain things?

I want to mention research from the London School of Economics, and concerns about the impact that everything that is happening has on the UK's voice in the shaping of the regulations:

"The weakened UK voice means that opposition to greater harmonization and EU calibration of international standards may be less strong in the Council than it was over the original CRD IV negotiations. Conversely, while the UK can be expected to support the proposal to lift certain of the contested CRD IV remuneration rules from smaller and less complex firms, other Member States may be less accommodating and more influential."

Again, that relates to the loss of the UK voice in all such matters. We end up in the worst of all worlds as a result of the decision. We become rule takers and have less influence over the things that affect financial services, which are a huge part of the economy of the UK and my constituency. I hope the Minister addresses those concerns.

9.17 am

John Glen: I thank the hon. Members for Stalybridge and Hyde and for Glasgow Central for their questions, and acknowledge concerns about the rigour of the process. All I can say to the Committee is that I am doing everything I can to ensure that it is as rigorous as possible.

For both statutory instruments, there was significant engagement with industry and the regulators. The draft Capital Requirements (Amendment) (EU Exit) Regulations 2018 were laid on 21 August, with an explanatory note seeking to draw out concerns. The draft Bank Recovery and Resolution and Miscellaneous Provisions (Amendment) (EU Exit) Regulations 2018 were laid on 8 October for consideration.

The hon. Member for Stalybridge and Hyde accurately characterised the global drivers of the regulations. I want to address the specific concern he raised about the directive on the change in capital requirements consequent on our leaving in a no-deal scenario. He is right to say that the capital requirements regulation specifies how much capital and liquidity firms must hold against different types of exposures. He is right that certain EU assets are subject to a 0% risk weight, meaning that no capital needs to be held against those exposures. However, in a no-deal scenario, the UK will treat the EU as a third country and vice versa.

Without an assessment of equivalence between the EU countries and the UK, the EU would end preferential capital treatment for UK exposures, so it has been Government policy not to grant the EU unilateral preferential treatment in the absence of equivalence, and the SI makes the appropriate amendments to ensure that EU sovereign debt is no longer treated more favourably than other assets of a similar nature.

Jonathan Reynolds: Will the Minister give way?

John Glen: Perhaps I may just make the next point, and see whether it addresses the hon. Gentleman's concern.

EU sovereign debt will none the less retain the low risk ratings that sovereign debt typically attracts. In addition, we are introducing transitional powers for the regulators to phase in the new requirements. That is up to two years, mitigating much of the impact.

Jonathan Reynolds: I am grateful for that clarification, and for the second point in particular. I understand the political case for not having a unilateral preferential regime that is not reciprocated by the EU. However, when we think about all the market volatility and stress that no deal gives us, to reclassify the capital adequacy of UK resident banks feels quite difficult, even if it is phased in over a period of two years, which is not that significant to be honest.

John Glen: I acknowledge how it sounds, but this is a regulatory change to enable the discretionary power. The Government's intent is to make prudential assessments in a non-politicised way.

Mr Richard Bacon (South Norfolk) (Con): May I say how delighted I am that the Government are taking an approach that allows discretion? That was one enormous problem at the time of the financial crash, which was also a sovereign debt crisis. The hon. Member for Stalybridge and Hyde forgot to mention who was in charge at the time. That crisis was exemplified perhaps most clearly by Gordon Brown standing outside the shiny new Lehman Brothers office when it opened, shortly before the crash. The capital regime was so inadequate at the time under that regime—

Jonathan Reynolds: In America?

Mr Bacon: In London. The point I was going to make, and why I am so glad that the Minister is introducing provisions for discretion, is that part of the problem of the sovereign debt crisis was that—

The Chair: I urge the hon. Gentleman to remember that interventions should be brief.

Mr Bacon: Yes indeed. Part of the problem with the sovereign debt crisis—perhaps the biggest problem—was the equal treatment of lots of different kinds of sovereign assets, such as Greek Government bonds, when in fact they were nothing like equal. That led to the distortion that helped to cause the problem.

John Glen: The Government and regulators are clear on the imperative to work closely with industry to ensure that change is not disruptive for firms. UK

[John Glen]

regulators will be given the ability to phase changes in over the next two years. We will treat all third countries similarly, which means, to answer the point made by the hon. Member for Glasgow Central, continuing to co-operate through international crisis management groups to plan and resolve issues with cross-border firms. The UK's participation, and enthusiasm to participate, in such forums will be undiminished. Nothing in the draft regulations will change how the UK co-operates with third countries.

The hon. Member for Stalybridge and Hyde raised the bank recovery and resolution SI and concerns around the appearance of disengagement. There is no intention whatsoever for the UK Government or regulators to be isolated in any way. We will continue to participate. However, these steps are necessary to domesticise our regulations in the context of a no-deal scenario.

The hon. Member for Glasgow Central has on several occasions, and perfectly sensibly, mentioned the regulatory burden and additional costs. She is right to draw attention to the £1.7 million assessment for the capital requirements SI and the £400,000 for the bank recovery SI. I point out to her that those are one-off familiarisation costs. For the 1,000 companies she mentioned, they are one-off costs of around £1,700 and £1,200 for some of the very biggest institutions. I accept that it would be desirable for them to not have those costs, but it will be necessary in a situation in which we do not secure a deal.

Sir Oliver Heald: If we were to import all European law into our law in a form that was ineffective and hopeless, would there be costs to the City and to our financial institutions of having an ineffective system? It is all very well for the hon. Member for Glasgow Central to criticise the cost of the regulations, but without them we would not have a system that works.

John Glen: My right hon. and learned Friend is of course correct. We are creating as smooth as possible a scenario in a no-deal situation. The costs would be much greater if we did not do so. However, I stress that we seek to maintain close relationships with all third countries.

Alison Thewliss: Will the Minister tell me a bit more about how the costs have been communicated to the 1,009 businesses and the 350 businesses that will be affected?

John Glen: As I mentioned, the regulations were laid on 21 August and 8 October. There was engagement with industry during that intervening period, and those costs will have been made clear during that time. We have tried to be as transparent as possible and to engage as closely as possible with different trade bodies and, through them, with firms, so that there is an understanding of the costs.

The Government believe that the regulations are needed to ensure that prudential and resolution regimes applying to banks, building societies and investment firms work effectively if the UK leaves the EU without a deal or an implementation period. We do not want to lose the progress in establishing these regimes that we have made over the last 10 years. I hope the Committee has found this sitting informative and will join me in supporting the regulations.

Question put and agreed to.

Resolved,

That the Committee has considered the draft Capital Requirements (Amendment) (EU Exit) Regulations 2018.

DRAFT BANK RECOVERY AND RESOLUTION AND MISCELLANEOUS PROVISIONS (AMENDMENT) (EU EXIT) REGULATIONS 2018

Resolved,

That the Committee has considered the draft Bank Recovery and Resolution and Miscellaneous Provisions (Amendment) (EU Exit) Regulations 2018.—(*John Glen.*)

9.26 am

Committee rose.