PARLIAMENTARY DEBATES

HOUSE OF COMMONS
OFFICIAL REPORT

Sixth Delegated Legislation Committee

DRAFT FINANCIAL SERVICES ACT 2021 (PRUDENTIAL REGULATION OF CREDIT INSTITUTIONS AND INVESTMENT FIRMS) (CONSEQUENTIAL AMENDMENTS AND MISCELLANEOUS PROVISIONS) REGULATIONS 2021

Wednesday 1 December 2021

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not later than

Sunday 5 December 2021

The Committee consisted of the following Members:

Chair: Julie Elliott

† Blackman, Kirsty *(Aberdeen North)* (SNP)
Bradshaw, Mr Ben *(Exeter)* (Lab)
† Bristow, Paul *(Peterborough)* (Con)
† Clarke, Theo *(Stafford)* (Con)
Coyle, Neil *(Bermondsey and Old Southwark)* (Lab)
† Elphicke, Mrs Natalie *(Dover)* (Con)
† Glen, John *(Economic Secretary to the Treasury)*
Lloyd, Tony *(Rochdale)* (Lab)
† McFadden, Mr Pat *(Wolverhampton South East)* (Lab)
† Mak, Alan *(Lord Commissioner of Her Majesty's Treasury)*
† Moore, Robbie *(Keighley)* (Con)
Ribeiro-Addy, Bell *(Streatham)* (Lab)
† Saxby, Selaine *(North Devon)* (Con)
† Smith, Royston *(Southampton, Itchen)* (Con)
† Twist, Liz *(Blaydon)* (Lab)
† Williams, Craig *(Montgomeryshire)* (Con)
† Wright, Jeremy *(Kenilworth and Southam)* (Con)

Seb Newman, Rebecca Lees, *Committee Clerks*

† attended the Committee

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Wednesday 1 December 2021

[JULIE ELLIOTT *in the Chair*]

Draft Financial Services Act 2021 (Prudential Regulation of Credit Institutions and Investment Firms) (Consequential Amendments and Miscellaneous Provisions) Regulations 2021

2.30 pm

The Chair: Before we begin, I remind Members that they are expected to wear face coverings and to maintain social distancing as far as possible. This is in line with current Government guidance and that of the House of Commons Commission. Members are also expected to do lateral flow tests twice a week before coming on to the parliamentary estate.

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

That the Committee has considered the draft Financial Services Act 2021 (Prudential Regulation of Credit Institutions and Investment Firms) (Consequential Amendments and Miscellaneous Provisions) Regulations 2021.

It is a pleasure to serve under your chairmanship, Ms Elliott. The regulations, among other things, support the implementation of the remaining Basel III standards and the investment firms prudential regime. As hon. Members will recall, after the 2008 financial crisis, the international community worked together to create new banking standards known as the Basel III accords. As a G20 member, the UK is committed to implementing the standards. The Government have legislated through the Financial Services Act 2021 to enable the Prudential Regulation Authority to update the UK's capital requirements regime to implement the remaining Basel accords, subject to an accountability framework.

In September, the House approved the Capital Requirements Regulation (Amendment) Regulations 2021 under the 2021 Act, which revoked the provisions in the UK capital requirements regulation necessary for the PRA to make these updates. The Act also enabled the Financial Conduct Authority to introduce the investment firms prudential regime, which is the UK's new tailored prudential regime for FCA-regulated investment firms. The regime carves FCA-regulated investment firms out of the UK CRR. The combination of these two prudential packages requires consequential changes to the statute book, and the regulations ensure that the changes mesh appropriately and provide a complete functioning legal regime for firms. Many of the measures in the regulations therefore update references in existing legislation to the UK CRR so that they now relate to the new rules made by the PRA, known as the CRR rules.

On the use of the Basel powers under the 2021 Act, the regulations revoke the reporting and disclosure requirements for the leverage ratio, which is a capital backstop that prevents banks from becoming excessively leveraged. To reassure hon. Members, the PRA was already able to set leverage-based capital requirements through PRA rules. The UK leverage ratio framework has been and continues to be set by the Financial Policy Committee, which recently reviewed it in its entirety. The regulations also remove a legacy equivalence determination on article 132, tied to an equivalence regime that was revoked as part of the Capital Requirements Regulation (Amendment) Regulations 2021 earlier this year. That change is simply tidying-up.

The regulations protect the status quo of CRR permissions by ensuring that firms do not have to reapply for permissions where the relevant article of the UK CRR is revoked and replaced with PRA rules. The regulations then make updates to support the effective implementation of the IFPR across the statute book. Some are straightforward, such as removing terminology that is now defunct due to changes made by the FCA through its IFPR rules. Initial capital requirements will no longer be set for some firms at €730,000, so references to such firms need to be deleted. Other updates, of which there are two notable instances, are more substantive where appropriate. First, the regulations extend the securitisation regulation's due diligence requirements to all FCA investment firms. That ensures that all FCA investment firms buying securitisations must conduct due diligence, thereby helping to safeguard the integrity of the UK securitisation market.

Secondly, the regulations remove Financial Conduct Authority investment firms from the UK resolution regime. This reflects the Government's view that the FCA's existing toolkit, along with the measures the FCA will implement in future through IFPR and the investment bank special administration regime are more appropriate ways of managing the failure of such firms. Indeed, FCA investment firms would currently use the existing rules in the first place and go into insolvency proceedings. Therefore, keeping them within the resolution regime only serves to create administrative costs for those firms, for no benefit.

The instrument also contains a savings provision and a transitional provision for the IFPR. It enables the FCA to continue to modify, revoke or amend IFPR-relevant technical standards, and allows for transitional provisions that support the functioning of the UK securitisation market by extending the existing risk retention requirements for one year, before they change once the IFPR is introduced. Risk retention ensures that firms retain an economic interest in a portion of the risk that is being sold on to investors.

Finally, the instrument addresses a small number of deficiencies arising from the withdrawal of the UK from the European Union that have been identified in the process of making these Basel and IFPR amendments. The Treasury has worked closely with the Bank of England, the PRA, the FCA, industry and, on the resolution change, the Banking Liaison Panel in drafting this instrument. I hope that I have shed light on some of the main elements of the instrument, and that hon. Members have found the explanation helpful. In short, it plays an important part in our work to build a financial system that is both responsive to the UK's specific needs and mindful of our responsibilities to the wider world.

I must inform hon. Members that a correction slip has been issued in relation to a typographical error in this draft instrument. The error is an incorrect cross-reference in the title of regulation 38. However, the operative provisions in that regulation are correct, and as a result the error has no legal effect and hon. Members can be assured that the change is minor. I therefore commend the order to the Committee.

2.37 pm

Mr Pat McFadden (Wolverhampton South East) (Lab): Thank you for chairing our proceedings today, Ms Elliott. I am also grateful to the Minister. The truth is that it is not easy to explain a set of regulations as complex as these, but their complexity should not disguise the importance of the content of some of these measures.

The instrument could be regarded as the son or daughter of the Financial Services Act 2021, which we debated this time last year, which in itself was the son or daughter of a number of European directives, so what we are really debating here is the grandchild of some European directives. The regulations do two main things: they onshore the implementation of the Basel III requirements under the capital requirements regulation and they establish the new prudential regime for investment firms.

There is a sense of déjà vu about these regulatory debates, partly because of that family tree. We debate the same things over and over again, first in primary legislation, in this case the Financial Services Act, and then in statutory instrument form. However, it is also because there are some common themes to the whole discussion about onshoring regulations in the post-Brexit future for our financial services sector, so let me ask the Minister a few specifics about the terms of the instrument. I must say, in that regard, I am grateful that this instrument was debated in the other place yesterday and we have the benefit of their Lordships' wisdom, for those of us who have had the chance to read that debate.

Let us start with the CRR, the regulation embodying our Basel III obligations—that is to say, the capital requirements agreed at an international level after the financial crisis. Like many of the directives we have onshored, the UK played quite a big role in writing it in the first place. First, I want to ask the Minister whether he can confirm that the onshoring of the CRR as set out in this statutory instrument does no more than change the supervisory body for implementing the Basel III rules, and does not change the terms of what the UK was going to do in that regard in any way? In other words, is it simply an onshoring process rather than a change in regulatory content?

My second question relates to the accountability framework of the PRA, who will take this job on. This issue was raised in yesterday's debate in the Lords. As the Minister will remember, the accountability framework for the PRA was amended during our debates on the Financial Services Act so that the PRA will have to have regard to our net zero commitments. However, that condition does not kick in until January of next year; does it apply to the changes made in this statutory instrument or not?

Thirdly, paragraph 7.17 of the explanatory notes refers to capital requirements. This is not strictly covered in this instrument, but may I ask the Minister about the capital requirement rules in relation to challenger banks and the rules on MREL—the minimum requirement for own funds and eligible liabilities? As the Minister knows, the Bank of England has consulted on this. Currently, we have a tougher regime on MREL than exists in the European Union or the United States. There may be good reasons for that, given the size of our financial sector, but the mid-tier banks say that it is a barrier to their growth and to competition in the banking sector. Can the Minister tell us anything about what is happening with the MREL rules for mid-tier banks?

The other major point in this SI concerns the investment firms prudential regime. This is not simply an onshoring; it is a new regulatory regime. It applies, as the explanatory notes confirm, to "non-systemic investment firms". In layperson's terms, that means investment firms that, if they fall over, do not pose a threat to the whole system. The first question on that is whether there is any increased risk to the public and the taxpayer by placing these non-systemically important firms in a different regulatory regime from the biggest seven or eight companies, which are covered by the capital requirements regulation?

The Government are making a distinction between deposit-taking and non-deposit-taking institutions. The explanatory notes say that to include all firms in the CRR would entail costs that are "disproportionate, burdensome and inappropriate". However, that is what people always say when they want to weaken regulation. The other side of that coin—whether it is disproportionate, burdensome or inappropriate—is risk. What account have the Government taken of the risks of separating out the companies into two different regimes, as this SI proposes?

As ever when there is a new task for the FCA, the question is whether it is equipped and resourced to handle it. There are reports of significant FCA vacancy rates and, of course, the organisation is still trying to recover from the London Capital & Finance scandal. How confident is the Minister that the FCA can implement the new prudential regime for investment firms mandated by this instrument?

I would like to ask the Minister a broader question about the Government's post-Brexit approach to financial services. The Chancellor has talked a lot about competitiveness being the guiding light for that, but does the Minister accept that it could set a direction that exposes the public to significantly more risk, and may not even be wanted by the financial services sector itself? I believe the Government are in danger of making a big and serious mistake here. Having left the financial services sector out of the Brexit deal, they give the impression of casting around to give the sector a deregulatory consolation prize, but that could pose big risks for the public, which we all know about.

First, there is the obvious risk that the UK could be made an easier home for illicit finance, fraud and money laundering. We already need stronger action on that front, not a weakening of the rules. Secondly, the public could be exposed to more risk in the event of company failures, and we should have learned how big those risks can be. The post-Brexit future for our financial services sector should not be a weakening of public protection in the name of competitiveness.

Finally, will the Minister therefore clarify exactly where the Government stand on this rhetoric about competitiveness? Is it really the Treasury's view that we should advertise around the world as a place where the referee will be weaker? If that is not the case, why does the Chancellor continually talk up competitiveness as the key factor in post-Brexit financial services regulation?

[Mr Pat McFadden]

2.45 pm

John Glen: I thank the right hon. Gentleman for his points, and congratulate him on his elevation to his new position. I am surprised, given the talent in the Opposition ranks, that he is still doubling up and wants to do this job as well, but I am delighted to see him here today, and hope that I will not have to see him here again. He raised six substantive points, which I am happy to go through. His characterisation of the draft regulations as being the grandchildren of the EU directives is reasonable and, as ever, puts things in a clear frame of reference.

First, the right hon. Gentleman asked me for some reassurance concerning the equivalent supervisory authority of the regime to deal with Basel III. I can totally reassure him that the authorities will ensure that they are not sub-equivalent to Basel. That means the Treasury working with the PRA and the FCA to place great importance on international standing, which will help to ensure that baseline level of resilience. As he acknowledges, the UK was critical in shaping the Basel standards, and we will continue, even in the new regime, to ensure that safety and soundness are at the core of our objectives.

The right hon. Gentleman's second point related to the point made yesterday in the other place with respect to the "have regard to" amendments to the FS Act. Obviously, our amendment to include a requirement to have regard to the net zero carbon target will apply after 1 January 2022. That means that the PRA does not need to have regard to climate change considerations in making the Basel III rules, nor the FCA in making the IFPR rules for 1 January 2022. That was done to ensure that there was no delay in implementing the Basel III reforms and the IFPR, but it will be for the regulators to determine going forward how the new duty will operate in practice. The Government anticipate that it should function in much the same way as other obligations during the PRA's implementation of Basel III standards, such as the need to have regard to the ability of firms to continue to provide finance to business and consumers in the United Kingdom. The key point is that, subsequent to the implementation agreed in the Act, they will have an ongoing obligation to have regard to these matters.

Mr McFadden: That sounds like quite an important omission. We do not need to go over the history of it, but the Government themselves tabled an amendment saying that the regulators had to have regard to our net zero obligations. If I understand the Minister correctly, he is saying that it does not apply to the draft regulations, which implement the Basel III regulations—the main international post-financial-crisis measure of regulating banks to ensure that the taxpayer is not on the hook in the future. Is that not quite an important omission from the green direction that both of us want to see for financial regulation?

John Glen: No, I do not think so. I think the Opposition accepted the Government's amendment with respect to its provisions on the timescale. That should not withdraw the urgent need to implement the Basel standards and the consultation process, which would have to have been repeated should we have had to wait until 1 January. That does not mean to say that on an enduring basis that will not be a consideration that the PRA and the FCA will need to have regard to.

Thirdly, the right hon. Gentleman's asked about the ongoing discussions around MREL for challenger banks. The Bank of England is leading that review, and is currently considering the responses to its consultation. I have received a number of representations and discussed the matter with several challenger banks. I am grateful to the industry for its engagement on that review. The Bank will respond in due course, but I should not imagine that it will be too far away.

The right hon. Gentleman moved on to ask about the classification of systemic and non-systemic banks, and used the expression "too big to fail" around how those definitions will work. There is no attempt to somehow manipulate those classifications for deregulatory effect; it is simply the case that there are much smaller firms that do not have that systemic risk. Therefore, it would be appropriate, within the context of the rules and frameworks of the FCA, for them to be under its jurisdiction. The same will not be true of those that are larger, but there is no motivation behind that other than to find the most appropriate regulator to do the most appropriate regulation.

The right hon. Gentleman then asked about the capacity of the FCA to deal with the new obligations, in the context of the outcomes of some of the challenges that it faced after LC&F. I obviously keep in regular contact with the chief executive of the FCA; indeed, I am speaking to him tomorrow afternoon. There is no question of its resourcing being somehow challenged to take on that responsibility. We discussed the matter with the FCA at length prior to the passage of the Financial Services Act earlier this year. That is a matter for the FCA, but I am convinced that it is in a good place to continue.

The right hon. Gentleman then asked a broader question about competitiveness, and characterised the motivation of the Chancellor and the Government as to perhaps offer a deregulatory pathway to industry. I know that the right hon. Gentleman was able to attend the UK Finance dinner last week. I hope that he noted the emphasis that I placed in my speech on the need not to differentiate our position on deregulation. Indeed, the consultation on a secondary growth and competitiveness objective does not in any way undermine, or seek to undermine, the primacy of high regulatory standards, which have distinguished our regulators and financial system for a very long time.

I hope that that addresses the points that the right hon. Gentleman raised, and I will conclude by briefly reiterating the purposes of the instrument. It enables the implementation of Basel III standards, which is key to the UK's international standing. It updates and accounts for the new IFPR definitions and takes FCA investment firms out of the scope of the UK resolution regime to reflect the new proportionate IFPR regime. Finally, it irons out some of the wrinkles of existing EU regulation. The measures will give UK firms certainty over the final elements of the Basel III standards and IFPR regimes, and I therefore commend the order to the Committee.

Question put and agreed to.

2.53 pm

Committee rose.