ALERT MEMORANDUM

The UK's Post-Brexit Financial Services Regulatory Framework – HM Treasury Consults on the Transposition of CRD V

July 17, 2020

On July 16, 2020, HM Treasury published a consultation on "*Updating the UK's Prudential Regime before the end of the Transition Period*". Responses are requested by August 19, 2020.

This consultation on the transposition of the Fifth Capital Requirements Directive[1] ("CRD V") was promised in HM Treasury's policy announcements on June 23, 2020 which set out the first concrete details of the UK's post-Brexit financial services regulatory framework ("June update").[2] We continue to await proposals on the UK's adoption of the Second Capital Requirements Regulation,[3] Investment Firms Directive[4] ("IFD") and Investment Firms Regulation[5] ("IFR") via the Financial Services Bill.

CRD V amends the Fourth Capital Requirements Directive[6] ("CRD IV", and as amended by CRD V, "CRD") as a step towards completing the implementation of the Basel III international standards in the EU. The UK is required to transpose CRD V, given that the transposition deadline of December 28, 2020 falls within the Brexit transition period which ends at 23:00 GMT on December 31, 2020. The legislation will, therefore, form part of "retained EU law" under the European Union (Withdrawal) Act 2018 ("Withdrawal Act"). HM Treasury expects to exercise powers under section 8 of the Withdrawal Act to remedy, mitigate or prevent deficiencies arising in this retained EU law to ensure that the UK maintains a functioning regulatory and legal framework following the end of the Brexit transition period. The Prudential Regulation Authority ("PRA") is expected to issue its own

[1] Directive (EU) 2019/878.
[2] *See*: https://www.gov.uk/government/news/regulatory-reforms-in-financial-services?utm_source=e542de87-0eb8-42e5-b587-01edbbb84951&utm_medium=email&utm_campaign=govuk-notifications&utm_content=immediate. For further information, see our alert memorandum, "The UK's Post-Brexit Financial Services Regulatory Framework – Details Emerge", available at: https://www.clearygottlieb.com/-/media/files/alert-memos-2020/the-uks-post-brexit-financial-services-regulatory-framework-details-emerge.pdf.
[3] Regulation (EU) 2019/876. HM Treasury has, however, published a document entitled "Covid-19 related amendments to the Capital Requirements Regulation and Second Capital Requirements Regulation (Regulation (EU) 2020/873)" which identifies which provisions of the recent so-called "CRR Quick Fix" will be retained EU law, available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/901083/CRR2.1_onshoring_approach_statement.pdf. For further details, *see* our alert memorandum, "CRR Quick Fix to Facilitate Lending in Response to COVID-19 Adopted", available at: https://www.clearygottlieb.com/news-and-insights/publication-listing/crr-quick-fix-to-facilitate-lending-in-response-to-covid19-adopted.
[4] Directive (EU) 2019/2034.
[5] Regulation (EU) 2019/2033.
[6] Directive 2013/36/EU.

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consultation on aspects of CRD V that will be transposed via its rulebook, including certain aspects of the changes to the remuneration rules under CRD V.

HM Treasury's proposals seem largely faithful to the relevant proposals of CRD V. An exception may be the gender neutral remuneration framework, on which the government has taken the view that no additional requirements are needed to implement the relevant CRD V provisions. The government is not the first to question whether any new law is needed to uphold the principle of equal pay for male and female workers for equal work or work of equal value which is enshrined in Article 157 of the Treaty on the Functioning of the European Union. CRD V tasks the European Banking Authority with issuing guidelines on gender-neutral remuneration policies.[7] It will be interesting to see if these guidelines create additional requirements for EU institutions. Notable absences from the consultation include the provisions on the leverage ratio buffer requirement and leverage ratio related maximum distributable amount. It could be that these may be implemented via PRA rules.[8] In addition, the consultation does not cover the provisions requiring an intermediate parent undertaking to be established by certain third-country groups.[9]

Solo-regulated investment firms will not have to implement CRD V

— HM Treasury announced in the June update that it plans to create a new prudential regime for investment firms ("IFPR") that will be "in line with the intended outcomes" of the IFD and IFR and that will follow broadly the same implementation timeline as the IFD and IFR – *i.e.*, Summer 2021. This new IFPR would apply to all FCA-authorized investment firms. PRA-designated investment firms, because of their systemic nature, would continue to comply with bank prudential capital requirements based on CRD V, CRR II and Basel III (and any subsequent update thereof).

— To avoid FCA-authorized investment firms having to implement first CRD V and then the new IFPR shortly thereafter, HM Treasury intends to exempt FCA-authorized investment firms from CRD V. FCA-authorized investment firms would, therefore, remain subject to CRD IV or other applicable existing prudential rules until the IFPR is in place.

Amendments to the list of entities exempted from CRD V

— In transposing CRD V, HM Treasury will exempt various EU entities from its scope.[10] However, these exemptions may be changed as part of the process for fixing deficiencies in retained EU law under the Withdrawal Act.

Capital buffers

— The CRD IV's other systemically important institutions ("O-SIIs") buffer ("O-SIIB") and systemic risk buffer ("SRB") are two of the main macro-prudential tools for addressing the risks posed by domestic systemically important firms. These are in addition to the Globally Systemically

[7] These will not be effective in the UK after the Brexit transition period. In any event, they are not expected until the first quarter of 2021.

[8] These provisions only apply from January 1, 2022 in any event. Furthermore, with the application of the leverage ratio buffer requirement postponed until January 1, 2023 by Regulation (EU) 2020/873, there would be no consequences resulting from a failure to meet that requirement as set out in Article 141c of CRD and no related restriction on distributions under Article 141b of CRD.

[9] This may also be due to the delayed application of the requirements in certain cases. Under CRD V, third-country groups with a total value of assets equal to or greater than EUR 40 billion as of June 27, 2019 shall have one or two intermediate EU parent undertakings, as applicable, by December 30, 2023.

[10] In addition to relevant UK entities. *See* Article 2(5) of CRD.

Important Institutions buffer ("G-SIIB"), which is used to address the risks posed by globally important institutions. The UK did not transpose the power to apply the O-SIIB, whereas the SRB is currently applied to ring-fenced banks and large building societies under a framework established by the Bank of England's Financial Policy Committee ("FPC").[11]

— However, CRD V requires that only the O-SIIB be used to address the higher risks posed by systemic importance (alongside the G-SIIB), as opposed to the SRB which cannot be used for this purpose. As a result, to ensure that the current level of macro-prudential flexibility and financial system resilience is maintained, HM Treasury intends to enact secondary legislation giving the PRA the power to apply an O-SIIB to replace the functions currently performed by the SRB. This framework would be similar to the current UK SRB. Accordingly, the FPC would be responsible for setting a high-level framework, and the PRA would be responsible for applying the O-SIIB to the same institutions as the current SRB (with power to vary this based on supervisory judgement).[12] The FPC would be required to periodically review the O-SIIB framework, whilst the PRA would have to review O-SIIB rates annually.

— In addition, CRD V amends the SRB to allow it to perform the function of setting so-called sectoral capital requirements ("SCRs") – additional capital for exposures to certain sectors – for a range of sectors and sub-sectors. HM Treasury intends to give power to the PRA to set SCRs via the SRB in respect of UK banks, building societies and PRA-designated investment firms on a solo or consolidated basis.[13] The CRD V SRB must be met with common equity tier 1 capital and will form part of institutions' combined buffer requirement. It cannot be used to address the risks posed by systemic importance (as these are already addressed by the O-SIIB and G-SIIB, as applicable).

— HM Treasury will give further consideration to the appropriate transposition of other changes to the SRB made by CRD V, with a view to maintaining current macro-prudential flexibility and ensuring the effective operation of the legal framework at the end of the transition period in a UK-only context.

New approval regime for financial holding companies ("FHCs") and mixed financial holding companies ("MFHCs")

— CRD V applies new requirements for FHCs and MFHCs to be subject to a specific authorisation regime, subjecting them to direct supervisory oversight to ensure that they can be held directly responsible for consolidated prudential requirements, without subjecting them to additional

[11] In line with recommendations from the 2010-2011 Independent Commission on Banking, the Capital Requirements (Capital Buffers and Macro-prudential Measures) (Amendment) Regulations 2015 require the FPC to establish a framework for an SRB that applies to large building societies that hold more than £25 billion in deposits (where one or more of the accountholders is a small business), and shares and ring-fenced bodies, within the meaning of section 142A of the Financial Services and Markets Act 2000. The regulations require the PRA to apply the framework set out by the FPC on the SRB from January 1, 2019.

[12] Separately, the PRA would still be required to identify O-SIIs using the existing framework. It is, therefore, not clear whether the O-SIIB could be applied to institutions which are not O-SIIs.

[13] At present, the FPC has powers of direction to direct the PRA to impose SCRs on UK banks, building societies and PRA-designated investment firms in relation to residential and commercial real estate, and financial sector exposures. The FPC also has the power to recommend that the PRA apply SCRs for a broader range of exposures. If the FPC were to recommend to the PRA that it implement SCRs for a set of exposures that are not covered by the FPC's powers of direction, the PRA currently could implement that recommendation by imposing additional Pillar 2 capital requirements. However, CRD V provides that Pillar 2 capital requirements should not be based on systemic risk.

prudential requirements on an individual basis. FHCs and MFHCs already existing on June 27, 2019 must apply for approval by June 28, 2021.

— HM Treasury intends to create a bespoke approval regime for FHCs and MFHCs (presumably UK FHCs or MFHCs in relation to UK consolidation groups), with scope for the PRA to supplement certain operational aspects (which the PRA will consult separately on). Applicants will be responsible for providing the PRA with the necessary data which will allow them to grant approval. The PRA will have powers to supervise, monitor, exercise discretions, impose additional requirements – such as fees – and enforce breaches of obligations in respect of FHCs and MFHCs. In particular, the government intends to transpose the powers included in Article 21a(6) of CRD (as amended by CRD V), which are:

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

— We assume that HM Treasury will also transpose the regime for exempting FHCs or MFHCs from approval under Article 21a(4) of CRD which would apply notably to acquisition vehicles[14] in certain cases.

PRA power to remove directors of institutions, FHCs or MFHCs

— The PRA will have an express power to remove a member of the management body of an institution, FHC or MFHC where the member is not of sufficient repute or does not possess sufficient knowledge, skills and experience to perform their duties.

Gender neutral remuneration policy

— HM Treasury does not intend to introduce additional requirements with regards to reporting and enforcement to implement CRD V requirements that institutions' remuneration policies should be gender-neutral – *i.e.*, based on equal pay for male and female workers for equal work or work of equal value. The government considers that the current reporting and enforcement framework that

[14] FHCs whose principal activity is to acquire holdings in subsidiaries or MFHCs whose principal activity with respect to institutions or financial institutions is to acquire holdings in subsidiaries (Article 21a(4)(a)).

is already in place under the Equality Act 2010 ("Equality Act")[15] will be sufficient to ensure that firms comply with their equal pay obligations.

— Likewise, the government is of the view that information provided by institutions under the Equality Act 2010 (Gender Pay Gap Information) Regulations 2017,[16] fulfils the requirements in CRD V that information on the gender pay gap is collected and published. The PRA will benchmark remuneration trends and practices using this publicly available information. There should, therefore, be no additional reporting requirements placed on institutions.

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[15] The Equality Act does not extend to Northern Ireland. The government is working with the Northern Ireland Executive to consider the requirements and their application in Northern Ireland.

[16] These require organizations with 250 or more employees to report on: (i) the difference between the mean hourly rate of pay of male full-pay relevant employees and that of female full-pay relevant employees; (ii) the difference between the median hourly rate of pay of male full-pay relevant employees and that of female full-pay relevant employees; (iii) the difference between the mean bonus pay paid to male relevant employees and that paid to female relevant employees; (iv) the difference between the median bonus pay paid to male relevant employees and that paid to female relevant employees; (v) the proportions of male and female relevant employees who were paid bonus pay; and (vi) the proportions of male and female full-pay relevant employees in the lower, lower middle, upper middle and upper quartile pay bands. They are enforced by the Equality and Human Rights Commission.