Classification: Public

UK FINANCE

A response to the PRA's consultation

Ring-fenced bodies: managing risks from third country subsidiaries and branches

November 2023

1. Introduction

1.1. UK Finance is the collective voice for the banking and finance industry. Representing over 300 firms, we act to enhance competitiveness, support customers, and facilitate innovation.

1.2. We welcome this opportunity to respond to *PRA's* *Ring-fenced bodies: managing risks from third country subsidiaries and branches* (the Consultation or CP 20/23).

1.3. Whilst the scale and importance of the industry to the UK economy necessitates a strong, effective and independent regulatory regime, we also need regulation that is proportionate and supports both competition and innovation, thereby helping the sector to grow safely and with confidence.

1.4. Our members, who are impacted by the ring-fencing regime, have contributed to this response. This includes the ring-fenced banking groups (RFBs), UK subsidiaries of non-UK firms with growing retail franchises in the UK and our associate member, Allen & Overy. As there was no standard 'blueprint' for ring-fencing and each financial institution implemented ring fencing in the most appropriate manner for their business model, and some of our contributors are not subject currently subject to ring-fencing, views on the near-term reforms and their impact vary between members.

1.5. The significant majority of our members believe that the ring-fencing rules should be removed and are disappointed that HMT has not taken up the spirit of the Panel's recommendations. A small minority of members consider that the ring-fencing regime is already working well as it is broadly implemented and do not believe significant parts of the HMT's short-term reform proposals and any related PRA proposals are needed.

1.6. The rest of this response reflects the view of significant majority of members, unless indicated otherwise, and sets out high-level observations on proposals in the PRA Consultation.

1.7. Some of our members will be responding bilaterally to the PRA Consultation.

2. Summary of relevant points from UK Finance's response to the HMT consultation

2.1. We consider that it may be helpful for the PRA to understand the industry's position with respect to the HMT consultation on near-term reforms as context for our response to CP 20/23, and hence set out some of our points made in response to HMT here.

2.2. We support HMT's intention to improve the functionality of the ring-fencing regime in the near-term by relaxing certain aspects and remedying some unintended consequences of the regime. Our members consider the near-term reforms an important first step in the evolution of the ring-fencing regime and support the implementation of a more flexible and adaptable regime. Our members appreciate HMT's intention to implement the near-term reforms swiftly. In the medium term, certain

aspects of the regime presently set out in secondary legislation would more appropriately sit in regulatory rules, thus implying an enhanced role for the PRA.

2.3. Overall, the significant majority of our members welcome the package of near-term reforms. They consider that the ring-fencing regime can be significantly improved, to enhance the international competitiveness of UK firms and limit the ongoing compliance burden of the regime, without introducing additional systemic risk. However, there are some questions from members on:

(a) whether the near-term reforms (which in part seek to address some unintended consequences of the existing regime) themselves create some unintended consequences,

(b) whether the proposed amendments to the Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014 (the **EAPO**) and / or the Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014 (the **RFBCAO** and together with the EAPO, the Secondary Legislation) achieve HMT's stated aims, or

(c) whether additional or further reforms might be appropriate.

2.4. Where members anticipate that the near-term reforms will give rise to potential unintended consequences, we have highlighted this below, particularly in relation to aspects in CP 20/23.

2.5. Among the unintended consequences identified is the expansion in the geographic scope of "core deposits". This would bring certain UK banks into the ring-fencing regime for the first time and impose unnecessary costs on ring-fenced groups with respect to non-EEA depositors.

2.6. A significant majority of our members support the proposal to allow RFBs to establish operations outside of the UK or the EEA, which is achieved via the deletion of Article 20 of the EAPO. Some of our members have previously encountered scenarios where potential mergers and acquisition (M&A) targets have had operations outside of the UK/EEA, meaning that target entities could not be held inside the ring-fence. This proposal would help with the ability to hold acquired entities inside of the ring-fence on Day 1.

2.7. However, the proposed change to the prohibitions under the EAPO is accompanied by a change to the geographical scope of the core deposits threshold under Article 2 of the RFBCAO, such that deposits held in branches outside the UK and EEA will be counted as core deposits (unless eligible for exemptions) for the first time. Our members consider that what constitutes a core deposit for the purposes of the threshold is unrelated to the third country activity permitted to be undertaken by an RFB.

2.8. The extension of the core deposit definition would have a number of consequences for UK banking groups whose UK non-ring-fenced banks (NRFBs) have non-UK/EEA branches, including significant upheaval for groups' structures and funding models with associated financial stability risks.

2.9. All UK banks would need to identify existing depositors with non-UK/EEA branches and assess and quantify which of these are core deposits (or would be but for an exemption under the RFBCAO for qualifying organisations, qualifying group members, or eligible individuals). All affected banking groups would face higher compliance costs, be it in maintaining the ability to identify these deposits on an ongoing basis or the more considerable costs of establishing ring-fencing if they are not currently subject to the regime or having their funding model disrupted if they are.

2.10. To the extent a bank is not subject to ring-fencing, it would need to assess whether the additional core deposits would put it over the £35 billion primary threshold and may as a result be ring-fenced. This would considerably disrupt regulatory certainty and the predictability of the UK as a financial centre.

2.11. To the extent the organisation is already subject to ringfencing requirements, it would immediately be in breach of these requirements, and would therefore need to transfer deposits to the RFB. Any

such transfers are likely to cause confusion and upheaval for non-UK depositors and considerably disrupt the funding models and liquidity positions for the affected NRFBs. This could directly impact their safety and soundness and create additional financial stability risks in financial markets as NRFBs simultaneously have to replace the lost funding.

2.12. There seems to be no meaningful UK financial stability gain, but substantial downsides and risks, in the inclusion of deposits held in non-UK or EEA branches in the calculation of the core deposits thresholds. We would recommend that the geographical scope of the definition rather be reduced to UK deposits only, as the inclusion of the EEA within scope is a legacy of membership of the EU and serves no real purpose in delivering financial stability benefits.

2.13. More broadly, the EAPO and RFBCAO should be reviewed in detail to ascertain whether it is appropriate to retain references to the EEA in other places.

3. Responses to PRA's proposals

Material risk rule

Rule 20: Third country branches and subsidiaries
A ring-fenced body must ensure that:
(a) any subsidiary undertaking of the ring-fenced body incorporated or formed under the law of a third country; and
(b) any branch established or maintained by the ring-fenced body in a third country,
does not present a material risk to the continuity of the provision in the United Kingdom of core services by the ring-fenced body.

3.1. We note that the current drafting for the proposed Rule 20 of the ring-fenced bodies part of the PRA rulebook (the material risk rule) requires RFBs to "ensure" that any third country branch or subsidiary does not present a material risk to the continuity of the provision of core services by the RFB in the UK. Our members consider that a more appropriate standard would be to require firms to "take reasonable steps to ensure" this outcome, particularly given the subjectivity of the factors that an RFB must take into account when assessing material risks to the continuity of service provision. This standard would be consistent with other similarly subjective and/or complex issues in the PRA Rulebook, for example Rule 3.3 of the ring-fenced bodies part.

ICAAP disclosure for non-UK subsidiaries or branches contributing over 5% RWAs

3.26 Accordingly, RFBs with non-UK subsidiaries or branches which individually or in aggregate contribute over 5% of the RFB consolidation sub-group's risk-weighted assets (RWAs) are expected to disclose this in their Internal Capital Adequacy Assessment Process (ICAAP). Here, they should also explain the steps taken to assess the materiality of risks posed to the continuity of the provision of core services from the RFB, and how they are mitigated.

3.2. Our members are comfortable with this approach.

Nature of third country supervision

3.27 The PRA expects that firms will ensure that any third-country subsidiary does not create a material risk to the RFB through the nature of supervision in the third country. This may include arrangements for resolution. When assessing if a firm is compliant and therefore whether action is needed to limit these activities, the PRA will consider the following factors, among others:
a. whether the host jurisdiction's prudential supervision regime is sufficiently equivalent to the UK regime; and

b. whether there is sufficient scope for supervisory cooperation between the PRA and the supervisor of the host state.

3.3. As drafted, this expectation would extend to EEA subsidiaries, which may exist as part of a RFB's sub-group under current rules. Our members consider that existing subsidiaries (whether service entities or banking subsidiaries) should not have to demonstrate regulatory equivalence. Given that these existing subsidiaries already operate, and the PRA is comfortable with them, requiring these subsidiaries to demonstrate regulatory equivalence would be an unnecessary burden, particularly given the alignment of UK and EEA standards. We request that the PRA apply this requirement only to new subsidiaries being created.

3.4. Furthermore, our members would like the PRA to provide certainty and clarity around the meaning of regulatory equivalence and the assessment of regulatory equivalence. RFBs need further guidance on how to judge whether a jurisdiction has clear or marginal regulatory equivalence.

3.5. Our members would also like further information on the interaction between the PRA's assessment of third country supervision and the wider UK equivalence regime run by HMT.

Expectation to identify, assess and mitigate risks to resolvability from branches and subsidiaries:

3.30 The PRA expects that firms that have or are seeking to establish non-UK subsidiaries or branches will identify, assess, and mitigate any issues related to the resolvability of the firm, or the resolution group of which it is a part, that may arise from establishing the subsidiary or branch. The PRA will, in consultation with the Bank of England (the Bank) as the UK resolution authority have regard to the firm's own assessment, and the requirements of Fundamental Rule 83, to determine whether or not there is a material risk to the continuity of core services in the UK.

3.6. Our members are comfortable with the proposals.

Timing of requirements

3.7. Our members request that the PRA provide clarity on when RFBs will need to first demonstrate that existing subsidiaries and branches comply with the three supervisory expectations. We consider that a transitional period following the introduction of the rule and expectations, in which RFBs can ensure compliance, would be helpful.

Unintended consequences

3.8. We note that HMT is currently consulting on changes to the EAPO, which include the proposed removal of Article 20 EAPO in Article 3(13) of the draft statutory instrument. The proposed removal of Article 20 removes the permission under Article 20(2) for ring-fenced bodies to have a participating interest in a non-EEA undertaking which is an ancillary services undertaking, if that undertaking does not carry on any activities that would be regulated activities if carried on in the UK.

3.9. Our members consider that without clarity, the PRA's proposals suggest that the material risk rule and the material risk conditions applying to ancillary services undertakings, would be a tightening of the current requirements. Additionally, we think that the first two material risk conditions are not sensible in the context of service entities, as service entities do not have risk weighted assets and are not regulated.

3.10. We would therefore request that the PRA clarify that the proposed material risk rule does not create any additional requirements in relation to service entities.

3.11. Furthermore, our members would like to highlight that the aim of the near-term reforms risks being undermined by PRA rules. For example, our members consider that to take advantage of the near-term reforms, RFBs may need to use resources or expertise currently housed in the NRFB to provide

relevant products and services to customers. However, the strict rules on reverse services in Rule 9 of the Ring-fenced Bodies Part of the PRA rulebook will limit the assistance and expertise that the NRFB can provide to the RFB, and therefore create friction in the uptake by RFBs of the wider range of activities permitted under the near-term reforms.

Other PRA expectations

3.12. Our members would like clarity on the extent to which any non-UK incorporated ring-fenced affiliates would still be subject to ring-fencing requirements in full. We note that these subsidiaries will be subject to compliance requirements under local legislation and that duplicative regulation should be avoided to reduce threatening the competitiveness of ring-fenced affiliates in their markets. For example, in some jurisdictions it may be more common to raise debt via loan notes or bonds, as opposed to loans. If the RFB subsidiary in a foreign jurisdiction is caught by the EAPO, it would not be able to enter into such structures as it may be considered dealing in investments as principal, rendering it unable to compete with other banks in that market.

Additional considerations

3.13. HMT proposes to allow a four-year transitional period for any bank acquired by an RFB to become compliant with the ring-fencing regime (see proposed amendments to Article 11 of the RFBCAO). This change is welcome – it will better enable RFB's to participate in M&A activity, including where a stressed financial institution needs rescuing. However, the PRA's expectation that an RFB will not have ownership rights or hold capital instruments in an excluded activity entity (per paragraph 2.3 of SS 8/16) means that the flexibility available to an RFB in the context of a bank acquisition is not available in the context of acquisitions of other financial services businesses. It would be helpful if the PRA were to confirm that the expectation expressed in paragraph 2.3 of SS 8/16 was subject to a similar 4-year transitional period. This would enable RFB's to consider M&A activity in the context of, for example, fintechs or wealth managers, where to do so was aligned to their business objectives and the needs of customers.

3.14. A significant majority of our members consider that there are aspects of the EAPO which would more sensibly sit in PRA Rules. This includes, for example, the derivatives position limits set out in Article 12. The Independent Panel had recommended that aspects of the ring-fencing regime would better sit in the PRA Rulebook and our members have been disappointed to see that such recommendations are not presently proposed for implementation. We would welcome the opportunity to further engage with the PRA on those aspects of the regime where we consider that greater adaptability over time would be welcome, and that the PRA might helpfully play an expanded role. For now, we would not want any discussion on these matters to delay the implementation of HMT's currently proposed near-term reforms nor any related PRA considerations.

3.15. The EAPO and RFBCAO should be reviewed in detail to ascertain whether it is appropriate to retain references to the EEA in other places (e.g. definition of mixed financial holding company, Article 2(3)(c) etc; Article 19A (2)(b) of the EAPO to the definition of infrastructure special purpose vehicle.

4. Conclusion

4.1. This response provides the collective views of our members, representing a broad cross-section of the industry, in so far as affected by the ring-fencing regime. Some of the RFB groups and others have provided or will provide separate bilateral responses to the PRA. We would be happy to explore any of the themes set out here or any relevant points from our response to the HMT consultation with the PRA.

Responsible executive

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