A response to the PRA's consultation paper CP25/18

The Bank of England's approach to amending financial services legislation under the European Union (Withdrawal) Act 2018

Christmas Eve 2018

Introduction

UK Finance is pleased to respond to the PRA's Consultation Paper CP25/18 on *The Bank of England's approach to amending financial services legislation under the European Union (Withdrawal) Act 2018.* It should be read in conjunction with our response to PRA Consultation Paper 26/18.

UK Finance represents nearly 300 of the leading firms providing finance, banking, markets and payments related services in or from the UK. UK Finance was created by combining most of the activities of the Asset Based Finance Association, the British Bankers' Association, the Council of Mortgage Lenders, Financial Fraud Action UK, Payments UK and the UK Cards Association. Our members are large and small, national and regional, domestic and international, corporate and mutual, retail and wholesale, physical and virtual, banks and non-banks. For many of our EEA and third country headquartered members their London operations are an important hub providing access for them and their clients to the international financial markets. Our members' customers are individuals, corporates, charities, clubs, associations and government bodies, served domestically and cross-border. These customers access a wide range of financial and advisory products and services, essential to their day-to-day activities.

The consultation is directly relevant to the large proportion of our members that are supervised by the PRA for prudential capital and liquidity purposes, so this response represents the views of a diverse cross-section of UK Finance's members.

General approach to making changes

We and our members are totally committed to ensuring that there is a fully functioning regulatory framework for financial services in place in time for the UK's formal withdrawal from the EU on 29 March 2019, in the event that there is no Implementation Period.

Although we understand that there is no formal requirement to consult stakeholders on the changes proposed in CP 25/18 we very much support the Bank and PRA's decision to do so, as well as the excellent dialogue that there has been between our members and HMT, the Bank of England and PRA as the relevant draft Statutory Instruments (SI), to which CP25/18 refers, have been created.

We support the clearly stated intention of the Bank and the PRA to only deploy the powers delegated to them under the '*Financial Regulators' Powers Regulations 2018*' draft SI to fix deficiencies in onshored Binding Technical Standards (BTS), rules for FMIs and the PRA Rulebook and that they will not be used to introduce any other changes in policy.

Capital neutrality

In our view, the move to a new legislative framework post-Brexit should be permanently capital neutral for UK banks, given that their risk profile remains unchanged.

To do otherwise risks adding further uncertainty to the UK economy and unforeseen systemic effects: for instance a limited impact analysis conducted during the summer indicated a potential RWA uplift of £25bn in relation to the risk weighting of EU-27 sovereign exposures , which will a significant negative effect.

Furthermore, the proposed approach will significantly undermine the ability of UK banks to arrange finance backed by European Export Credit Agencies. The subsequent reduction in banks' capability in this segment of the market will also negatively affect their ability to support UK Export Finance, compounding the damaging effect of the anticipated increases in RWAs that EU regulators will impose on UK sovereign exposures in the absence of equivalence arrangements.

While some of the issues that cause RWA inflation may be solved by equivalence decisions, this is not universally the case. For example, the ability to opt sovereign exposures from the internal ratings based ('IRB') approach onto the standardised approach under Article 150 (1) (d) will not be subject to equivalence, which could have a material impact on RWAs. In such cases, particularly those where the regulatory framework is subject to change at an international level, no changes to the UK's current regime should be applied.

Similarly, where the PRA has the power under the CRR to adopt a more punitive approach it should refrain from automatically applying this. For example, the PRA has chosen to automatically increase the risk weights for EEA commercial mortgages to 100%, exercising its power under Article 124. In this respect, the PRA has not only appeared to have made a policy decision, contrary to its stated intention, but has done so without publishing the analysis justifying its decision.

General approach to the use of the temporary transitional power

Transitional Period

In the absence of the permanent capital neutrality, we welcome the PRA's indication that a transitional period will be applied to the changes. In particular, we welcome the proposal that,

during the transition period firms and FMIs will be able to continue to treat EU27 exposures and assets preferentially, in accordance with CRR's capital, liquidity and large exposure regimes. The impact of not being able to do so would be particularly significant in relation to the extra capital our members would have to hold against their holdings of EU27 government bonds used for liquidity management purposes.

We recognise that the length of the transitional period will be governed by the powers given to the PRA under the Transitionals SI. But wherever possible, rather than the proposed period of two years, the transitional period should be linked to the timetable for the implementation of the changes to the regulatory framework that are currently in progress at an international level, such as the Basel III reforms.

For example, in relation to any changes that affect sovereign exposures, the transition timetable for credit risk and large exposures should mirror the implementation of Basel's proposed changes, if any, to the global sovereign risk framework, should this be agreed. Similarly, for those areas of the sovereign rules that are affected by the Basel III reforms, such as the sovereign CVA exemption, the transition period should be aligned to the start date of those reforms, on the 1st January 2022. To do so would remove any unnecessary volatility in regulatory metrics that would not reflect a change in banks' risk profiles but may none the less be experienced between the end of the Implementation Period and the commencement of the internationally agreed Basel III changes.

For the intra-group CVA exemption, we have assumed that HMT's EMIR transitional period of three years for such transactions would prevail over the PRA's two year transitional. Whilst this may give time for the new CVA regime to be implemented, the transitional exemption should remain linked to the implementation of the new CVA rules under the Basel III reforms as a backstop. Similarly, the pensions CVA exemption should remain in place until the new Basel III reforms apply, even if the EMIR Regulatory Fitness and Performance ('REFIT') proposal does not come into force before the UK leaves the EU.

Scope of transitional provisions

There remains considerable uncertainty among industry participants regarding which provisions are subject to transitional provisions.

Our members' concerns arise from the style of the preamble to each of the chapters in CP26/18. In some chapters, for instance Chapter 5, there is a clear statement that proposals therein would be delayed for the duration of transitional relief. Other chapters, for instance at 4.2, which is most relevant to our members, indicate that the PRA is still considering the use of their transitional powers and that the proposals in the chapter should be read in that context.

The list of items subject to transitional provisions that is provided in paragraph 4.10 is characterised as non-exhaustive. Similarly, the list in paragraph 4.11 of specific areas where changes must be made on exit day may also be read as non-exhaustive.

The position is rendered even more unclear by paragraph 4.12, which details the PRA's intention not to delay the application of textual onshoring changes where no specific action would be needed for firms to continue to meet their regulatory obligations from exit day.

As a result, and because of the more conjectural wording in CP26/18, there is lack of certainty by firms about the provisions that are to be applied on exit day. For the avoidance of doubt, we would ask that the PRA could specify precisely which amendments contained in the

consultation package it envisages fall within the transitional provisions as soon after the consultation period closes as possible.

Uncleared derivatives

We have identified a further key issue that we strongly urge the PRA to include in the list of areas to which it will apply transitional relief.
The PRA currently envisages that the proposed amendments to the uncleared swap margin rules, arising as a result of the changes to the EMIR RTS on risk mitigation techniques for uncleared derivatives, should be implemented from exit day.

In particular, the range of eligible collateral would be amended, such that EU Member State government debt securities would cease to be eligible on the same basis as UK government equivalent instruments, although we recognise that they may be eligible as third country debt securities, depending on a credit quality assessment. A similar limitation would also apply to other EU issued instruments.

The PRA is also proposing that references to credit institutions authorised in accordance with CRD (or 'equivalent" third country) to act as custodians for cash Initial Margin (IM) be replaced with references to institutions authorised by the PRA (or equivalent third country). We recognise that in CP26/18 the PRA recognises this may create problems for credit institutions that currently provide services to UK counterparties subject to IM which are based in EU Member States other than the UK. Although currently cash is not used as IM for Phase 1, 2 and 3 firms, we expect cash to be utilised by many phase 5 counterparties.

Our members are of the view that it will be impossible to comply by exit day with the proposed changes to the uncleared swap margin rules, as to do so would require the repapering of bilateral agreements, as well as changes to the arrangements counterparties currently have in place to exchange collateral for derivative transactions. For example, collateral schedules will need to be amended to reflect the changes to collateral eligibility rules. Counterparties will need to update operational processes to ensure adequate eligible collateral is available for exchange. Legal documents and collateral agreements will need to be amended and systems upgrades required as the UK becomes a separate regulatory/legal jurisdiction from the EU. For a typical member active in the derivatives markets, the exercise would involve amending 10,000 – 20,000 bilateral agreements. It should be recalled that the implementation of the uncleared derivatives RTS took more than two years. Regulators had to issue forbearance statements to address industry inability to implement by the original implementation deadline, on account of the sheer volume of documents requiring remediation.

Accordingly, the changes to the RTS proposed in the consultation paper should be subject to a transitional period of at least two years to give market participants sufficient time to comply with them. In addition, such a reasonable time period would allow market participants to wait for equivalence decisions to be taken by the UK and EU vis-à-vis each other in respect of the uncleared derivatives margin rules under Article 13 of EMIR and the relevant onshored UK version of this regulation. Market participants would then be able to implement the changes proposed in the consultation paper, taking into account the impact of such equivalence decisions, thus avoiding two rounds of repapering and operational changes.

Finally, the consultation paper proposes to delete the Phase 4 and 5 provisions in the RTS on the ground that they fall after Brexit day and therefore would not be part of UK domestic law at that point. In addition, Article 38 provision of the RTS which brings single stock equity options back in scope after a three-year derogation is removed and these instruments are therefore permanently exempted. The consultation paper states that firms should plan on the assumption that requirements arising from new EU legislation that comes into effect during an Implementation Period lasting until 31 December 2020 would apply to them. The industry needs clear guidance as to how the PRA intends to replicate the phase-in provisions currently in the RTS. Clarification is also required around the variation margin (VM) rules for deliverable FX products under EMIR, to ensure that previous guidance is still applicable. The consultation paper does not address the draft RTS that is under review by the European Commission, which could therefore result in these products becoming in scope for the VM rules from exit day in the event that there is no Implementation Period. This would result in significant market disruption, as the industry would probably block trading until agreements are confirmed and operational capabilities established.

FSCS Protection

Financial Services Compensation Scheme (FSCS) coverage is one of the three areas where the PRA does not propose to grant transitional relief under the temporary transitional power in respect of proposals. As a result, the changes would apply in full from exit day in the event that there is no Implementation Period agreed. When the UK leaves the EU, it will no longer be subject to the interconnected depositor protection provided by EU Member States. So deposits held by UK firms' branches in the EEA will no longer be protected by the FSCS but will instead be covered by the relevant EEA schemes. Additionally, FSCS would only protect depositors with eligible deposits held by UK establishments of firms with Part 4A permissions (granted or deemed) to accept deposits.

We believe that the PRA currently envisages that the proposed amendments to depositor and dormant account protection, as set out in the draft Supervisory Statement at pages 39 to 44 of CP 26/18 and Annexes R and S at pages 84 to 100, will be implemented with varying dates but most between exit day and two months after exit day.

Our members are of the view that it will be impossible to comply with the requirements by the prescribed dates, in particular those close to exit day, as there will be insufficient time once the final rules are published to meet the timescales outlined in the paper. The amendments require updates to customer marketing material; both physical documents (such as printed and digital literature) as well as virtual documents and systems (screens, scripts and systems triggered communications). Additional technical changes are also required, especially in relation to the Single Customer View reporting capability.

The communication and notification requirements are challenging within the proposed timescale, albeit, that some of the implementation could be achieved if coordinated by FSCS (e.g. cross industry communication). The last time there were such extensive changes there was a much longer implementation period than is proposed in the consultation paper.

Given the uncertainty of the Brexit negotiations, implementing all these changes, will take longer than the three months proposed, if no Implementation Period is agreed. We would request the PRA reconsider the FSCS proposals and provide adequate time for implementation.

In addition, our members have interpreted the requirement in section 13.11 of the Supervisory Statement to provide the revised information sheet and exclusion lists to all existing depositors by 30 May 2019 as applying only to *new* scheme members (i.e. to EEA firms which were previously passported into the UK and who will provide services after exit day under the temporary permissions regime). We would appreciate clarification from the PRA that this is the case and that UK-authorised deposit takers will not be subject to the requirements in this section.

Senior Managers and Certification regime

The FCA's proposals state that during the Temporary Permissions Regime (TPR) the existing EEA Branch regime, will continue to apply until 1 January 2021 (or the date of authorisation, if earlier). However, contrastingly, in the event of a No-Deal Brexit, the PRA proposes that all firms currently operating in the UK under the EU passporting regime and wanting to continue operating in the TPR will be treated as third country branches from the day of the UK's withdrawal from the EU.

In relation to the SMCR, this would mean that dual regulated firms in the TPR could be required to have at least one Senior Management Function (SMF)19 approved - in some instances more - under the PRA regime, but no change to Senior Manager arrangements under the FCA, with for instance, the CEO of the London branch overlapping continuing as an SMF 21. This is of concern since the SMCR was designed to ensure no gaps or overlaps in firms' governance structures, which would appear to be an unintended consequence of the FCA and PRA's differing approaches.

We have already raised our concerns about how the FCA and PRA regimes will co-exist during the TPR and have had good joint discussions with both regulators with a view to identifying a solution. We suggest that for the duration of the TPR any Prescribed Responsibilities (PR) which feature in the third country firm regime are "switched off" until a firm is authorised as such by the PRA and the FCA and that regime applies in full. If this would not be possible, we strongly suggest that the PRA discusses with the industry whether a subset of these PRs could be disapplied to ease specific concerns about SMF overlaps between the FCA and PRA.

EU Guidelines and Recommendations

We note that the list of the European Supervisory Authorities' ('ESA') Guidelines and recommendations that the PRA expects firms to comply with is currently not exhaustive; however, in order to ensure a consistent application of the legislation, we would ask that the PRA provide such a list ahead of the date of the UK's withdrawal. Furthermore, we would request that the PRA clarify whether the guidance issued via the ESA's Single Rulebook Q&As will continue to apply following the UK's withdrawal.

Data sharing

We understand that there will be no continuing formal obligation to share information and cooperate with EU authorities. However, we like the UK regulators, are strong supporters of co-operation mechanisms and welcome the intention to continue to actively engage with supervisory colleges and crisis management groups around the world.

Alignment with other regulatory initiatives

There are many other regulatory initiatives that are being undertaken during the transition and beyond as banks prepare for changes arising from the SSM's TRIM exercise, the EBA's IRB programme, in the UK changes to the days past due definition of default as well as preparing for the modelling changes arising from the finalised Basel II framework.

Over 1,000 model change approvals are expected over the next couple of years, which is clearly a significant task for both the PRA and the institutions it supervises. Challenges arise because of the complex links between the Internal Ratings Based approach, IFRS 9 stage 3, Definition of Default, stress testing, Non-Performing Exposures/Forborne Exposures and regulatory reporting and implementation dates that are differ or are unclear.

The transition period should be extended to accommodate this multiplicity of sequential changes through to the introduction of the Basel III framework in 2022. We would be delighted to discuss this important issue with the PRA as soon as possible.

We hope these comments will prove helpful as the PRA works to ensure that there is a fully functioning regulatory framework for financial services in place in time for the UK's formal withdrawal from the EU on 29 March 2019, in the event that there is no Implementation Period. Of course would be delighted to discuss them in more detail, if appropriate.

Responsible Executive

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