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Brexit Law – your business, the EU and the way ahead

Brexit Statutory Instruments – a series of briefings

November 2018

Capital Requirements (Amendment) (EU Exit) Regulations 2018

This paper is part of a series of briefings for clients and contacts of Allen & Overy on the review of financial services statutory instruments (**SIs**) to be laid down under the European Union (Withdrawal) Act 2018 (the **Withdrawal Act**).

Introduction

The Capital Requirements (Amendment) (EU Exit) Regulations 2018 (the **CRR SI**) amend the EU Capital Requirements Regulation (**CRR**) and various domestic legislation relating to prudential regulation of banks and investment firms. The CRR SI is intended to "onshore" the CRR and its delegated Regulations, which amend associated provisions in UK implementing legislation, in the case of a hard Brexit. The purpose is to prevent, remedy or mitigate any failure of the legislation to operate effectively and to correct any other deficiency in the CRR and associated provisions when transposed into UK legislation. CRR will largely become part of UK domestic legislation unchanged. The SI is not intended to make policy changes other than to reflect the UK's new position outside the EU. The changes in the SI will not take effect on 29 March 2019 if a transitional agreement is reached.

Following comments on the first draft CRR SI, the government has circulated a second draft CRR SI addressing key omissions and points raised by the industry.

What does the CRR SI do?

The CRR SI makes only minimal changes to the CRR when bringing it into domestic legislation. Any divergences in requirements and application of the rules are at this stage likely to be limited. The primary implications for firms arise from the need to treat the EU27 as third countries, with the expectation being that the UK will similarly be treated by the EU as a third country.

The proposed amendments in the text are largely to replace references to EU bodies and legislation with reference to the relevant UK bodies and legislation and to the relevant parts of the PRA Rulebook and FCA Handbook. The CRR SI also grants a number of regulatory powers to the UK authorities.

Key points to note on the impact of the onshoring include:

Alignment of the treatment of EU states with that of third countries in UK legislation

References in the CRR to "member states" or the "Union" will be replaced with references to the UK. The effect of this is that EU member states will become third countries for prudential regulatory purposes for UK banks and investment firms. Following the UK's exit, they will have no special treatment under UK law.

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Changes to consolidation

There will no longer be a concept of an EU consolidation group in the UK, and the definitions relevant to consolidation will be amended to remove the related definitions, for example "EU parent institution" will be omitted when the CRR becomes a part of UK law.

The approach towards the CRR's secondary legislation

– **Technical standards**: in general the approach is to transfer powers to the PRA and FCA to make technical standards. References to EU bodies doing so are removed.
– **EBA guidelines**: it is expected that these will be adopted by the PRA.

Equivalence

The CRR includes a number of preferential treatments based on equivalence of third-country rules. The CRR does not provide any passport-like rights for third countries, even for wholesale banking business. CRD IV/CRR equivalence is limited to the prudential treatment of certain types of exposures to entities located in non-EU countries. It currently allows EU-based institutions to apply preferential risk weights to the relevant exposures in third countries whose prudential supervisors and requirements are deemed equivalent to the EU by the Commission. CRR equivalence clauses are irrelevant in terms of EU market access for third-country firms.

The Treasury will be given powers to make equivalence decisions in the UK. As yet it is unclear if firms will be able to treat the EU as equivalent. Clarity is needed from the UK to ascertain, whether the UK will make an equivalence decision with respect to the EU under the following articles:

– **Article 107(4) CRR**: This allows institutions to treat exposures to third country investment firms, credit institutions and exchanges as exposures to similar EU financial institutions. This impacts their credit risk weighting, but also potentially their eligibility as credit risk mitigation providers.
– **Articles 114, 115, 115 CRR**: The specific risk weights applicable to exposures to central governments, central banks, regional governments, local authorities and public sector entities may apply to similar entities located in third countries for the purposes of calculation of the capital ratio of EU financial intuitions.
– **Article 132 CRR**: An exposure to a CIU managed in a third country where an equivalence decision has been made may benefit from preferential treatment where all relevant conditions are fulfilled.
– **Article 142 CRR**: A subsidiary located in a third-country can be taken into account for the definition of "large financial sector entity".

Legislation amended by the CRR SI
Regulated Covered Bonds Regulations 2008
Capital Requirements Regulations 2013
Capital Requirements (Country-by-Country Reporting) Regulations 2013
Capital Requirements (Capital Buffers and Macro-prudential Measures) Regulations 2014
Capital Requirements Regulation (EU 575/2013)
Capital Requirements Directive (EU 36/2013)
Liquidity Commission Delegated Regulation (EU 61/2015)
G-SII Commission Delegated Regulation (EU 1222/2014)

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Areas identified by industry as requiring further consideration

Key comments on the draft CRR SI are as follows:

Delegated powers

- **Enhanced prudential measures**: Regulation 202 of CRR SI restates Article 458 of CRR, which grants to the Financial Policy Committee (**FPC**) powers to apply enhanced prudential measures. However, the CRR SI does not contain an equivalent provision of Article 458(2) of CRR, which requires the FPC to produce certain evidence in relation to the enhanced prudential measures. Further clarity is required on whether any such requirements will apply post-exit.
- **Wide-ranging powers**: Regulation 206 of CRR SI grants to the Treasury powers to make regulations containing incidental, supplemental, consequential, and transitional provisions. It also grants powers to the PRA and FCA to make technical standards to ensure the CRR SI remains fit for purpose. There is a concern that these powers may be used to implement policy changes, and more generally that there is a lack of clarity on the process for amending the UK prudential regulatory framework post-exit.

Definitional issues

- **Interpretation**: the CRR SI contains references to EU legislation as it "has effect from time to time". Further clarity is required as to whether this refers to how the legislation has effect in the EU or in the UK from time to time.
- **Regulatory rulebooks on exit day**: the CRR SI contains new interpretative provisions which make reference to regulators' rules as "in effect on exit day". Our expectation is that this will have the effect of creating two separate versions of the PRA Rulebook and the FCA Handbook. The first version as in force on exit day would be used for the purpose of interpreting certain SIs in the future. The second version would be used for interpreting other UK financial services legislation. This may make compliance more complex when the rules are amended. It is also unclear whether the PRA and FCA intend to make available a separate version of the Rulebook and Handbook as on exit day.
- **New definition**: the CRR SI contains a new definition of "Directive 2013/36/EU UK law" which refers to the law of the UK and any part of it in force immediately before exit day implementing CRD IV and its implementing measures. It is unconfirmed whether the Treasury intends to make available a complete list of law that "implements" CRD IV. There are also two different versions of the definition used in the CRR SI. Industry would like to discuss the reason for this inconsistency.

What does this mean for you?

A number of consequences arise for UK firms associated with EU27 clients and counterparties being treated as third-country clients or counterparties. These include the following:

- The risk weighting of exposures of UK investment firms to EU27 governments, which will no longer benefit from an automatic 0% risk weight under Article 114(4) CRR. The risk weight will depend on the credit rating of the relevant government. This is subject to the UK making an equivalence decision with respect to the relevant EU government (see equivalence below).
- EU regional governments and local authorities will no longer benefit from an automatic 20% risk weighting under Article 113.
- EU27 organisations which are currently treated as exposures to the relevant government will no longer receive such treatment, unless an equivalence decision is made, as set out in further detail in the "Equivalence" section above. It is likely, depending on the facts of the case, that they would be risk weighted as either a corporate or an institution based on their credit rating.
- It appears that, under the standardised approach, covered bonds issued in the EU will no longer benefit from preferential treatment and will be treated as exposures to institutions.
- EU27 sovereign assets will no longer automatically qualify as Level 1 high quality liquid assets. They will need to satisfy credit quality steps to qualify as Level 1.

– In practice, the most material impact of the changes in consolidation will be in limited circumstances where it may be possible to have an investment firm in the UK and a parent company or parent investment firm in the EU without consolidating them. However, where a group already has consolidation in the UK, it is likely that EU subsidiaries would still be captured as a part of the consolidation group.
– As yet it is unclear if firms will be able to treat the EU as equivalent, under the Articles set out in the "Equivalence" section above. Clarity is needed from the UK to ascertain, for example, if EU credit institutions and investment firms can be treated as such when assessing credit risk and credit risk mitigation.

Next steps

HM Treasury intends to put the CRR SI before Parliament this autumn.

Your Allen & Overy contacts

For further information please speak to:

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