Sir William Cash  
Chair  
European Scrutiny Committee  
14 Tothill Street  
House of Commons  
London  
SW1H 9NB  

28th February 2018

Dear Bill,

EM 14777/16, 14775/16 and 14776/16: On amendments to the Banking Recovery and Resolution Directive (BRRD) and the Capital Requirements Directive (CRD) and Capital Requirements Regulation (CRR).

Following my letter dated 23 January and your Committee’s subsequent report, I am writing to provide you with an update on the progress of negotiations on the Commission’s risk reduction package which amends bank capital and resolution rules.

The Presidency has scheduled the package to go to General Approach at ECOFIN on 13 March. We believe that there is a pathway to reaching a compromise on the outstanding issues that meets our negotiating objectives; that the package is consistent with international standards; the rules do not disadvantage UK based banks following or during negotiations to withdraw from the EU; and supervisors and resolution authorities have necessary powers and flexibility above internationally agreed standards to pre-empt and react to financial stability risks. Official level discussions continue at a pace, but progress to date on these issues is outlined below.

Regarding the Pillar 2 proposals, we expect a compromise where the loss of Pillar 2 tools for macroprudential purposes are appropriately compensated for. In aggregate, we have successfully pushed for amendments which will ensure revisions to the macroprudential toolkit will not materially impair the Financial Policy Committee’s ability to promote and enhance UK financial stability. In particular, we have been able to introduce language that provides the Prudential Regulation Authority (PRA) the legal certainty to apply certain ‘non-capital’ tools across the market at once, such as loan-to-value (LTV) limits. We have worked with others to improve a number of existing Pillar 2 tools, making them more suitable for dealing with macroprudential risk, this includes powers to mitigate real estate risk. We also believe that the current compromise text will allow the PRA to retain the ability to apply tougher capital buffers to ring fenced banks in line with the recommendation of the Independent Commission on Banking. We will
continue to push for further improvements ahead of ECOFIN and seek an outcome that ensures supervisors in the UK will have the necessary toolkit to mitigate stability risks.

We have made significant progress with the Intermediate Holding Company (IHC) proposal. As outlined previously, the power to require international banks to establish EU holding companies is something that already exists under CRDIV. As a consequence, our concerns related primarily to the disproportionate impact of these new requirements and the approach taken by the Commission, in presenting these proposals without an impact assessment or appropriate discussions with Member States ahead of their publication. This is a point the Chancellor has made twice in statements at ECOFIN.

Therefore, we have continued to work with likeminded Member States and the Presidency on compromises which are designed to increase the proportionality of the measure, and we expect to achieve a number of positive changes. We have worked to include measures in the compromise text which increases the thresholds of application, from €30bn to €40bn of EU assets, and removing the application to global systemically important institutions (G-SIIs) that fall under that threshold. The latest text allows for more efficient structures in the EU (particularly dual hold-cos to reflect foreign regulatory requirements including our own ring-fencing regime post Brexit), which is where the greatest costs to industry would have been felt. The Commission’s initial proposal would have imposed the creation of a single IHC, conflicting with third country legal frameworks for banks that require a separation of retail activities from wholesale banking (such as ring fencing in the UK or the Volcker Rule in the US) and could be impossible, or at least incredibly costly, for firms to meet.

We have introduced a long transition period to reduce uncertainty and complexity for firms who already must manage challenges with post-Brexit restructuring – the requirement will come into force four years after the Directive applies. We have also been able to introduce a review clause which ensures that the Commission, in consultation with the European Banking Authority, will review the IHC requirement to consider whether requirements are operable, necessary and proportionate and if the proposal should be revised to reflect international developments. We have also been successful in preventing the extension of these requirements to branches, as pushed by the European Central Bank (ECB) and the Single Supervisory Mechanism (SSM).

In terms of your request for further analysis on the specific impacts on UK based firms, unfortunately it is very difficult to address at this stage, as the application depends entirely on how those firms will be structuring themselves post Brexit. Our primary focus has been on ensuring proportionality, and delaying application to prevent further complexity for firms.

We therefore believe we will be able to support the outcome of negotiations in the interest of a balanced overall compromise that delivers appropriate levels of international harmonisation and supervisory flexibility.

The UK has managed to maintain proportionality with regards to remuneration in negotiations by largely retaining the status quo. This means that the approach can be
tailored to ensure its effectiveness in respective markets, which will allow us to continue
to disapply the bonus cap for smaller firms, preventing the creation of a significant
administrative burden.

We have largely achieved our objective on international harmonisation with current
compromises generally seeing full Basel implementation (following acceptable transition
periods) including the introduction of the Net Stable Funding Ratio (NSFR). Regarding
the Leverage Ratio, there is broad consensus to introduce the international standard of
3%, with an appropriate transition period and the inclusion of Basel’s recently agreed.
additional buffer for global systemically important banks (G-SIBs). On Market Risk, we
expect an outcome which will commit the EU to full implementation of Basel’s revised
market risk framework.

The remaining parts of the risk reduction package include several important changes to
the Bank Recovery and Resolution Directive (BRRD). Notably the changes introduce the
Financial Stability Board’s (FSB’s) total loss absorbing capacity (TLAC) standard into EU law
and updates the framework for setting the EU’s minimum requirement for eligible
liabilities (MREL).

Several challenges remain on overall MREL calibration. This is an area of the package which
is still moving. The UK and like-minded MS continue to advocate full implementation of
FSB’s TLAC standard for globally systemic banks (GSIBs) and flexibility for the resolution
authority to set an appropriate amount and quality of MREL to support the preferred
resolution strategy. To date, Member States remain divided between those Member States
that want to faithfully implement the FSB’s TLAC standard and maintain the current MREL
standard, and those Member States that want to weaken the standard. The Presidency is
working to find a compromise. There has been some progress in the right direction to
date. In the current text the Commission proposed cap on the amount of ‘hard’ MREL has
been removed to allow resolution authorities to increase the amount of MREL to ensure
a bank can command sufficient market confidence to continue to meet the conditions for
authorisation following a resolution, and the new concept of ‘soft’ MREL guidance has
been removed.

However, in the current text part of a firm’s MREL requirement may only be met with
subordinated liabilities up to 8% of total liabilities and own funds. This restriction is
inconsistent with the TLAC standard which envisages the full subordination of TLAC and
the current MREL standard which does not restrict the subordination of MREL. The ability
to subordinate MREL resources is important to ensure MREL ranks below liabilities related
to day-to-day operations and critical economic functions and can therefore absorb losses
and recapitalise the continuing business. The Bank of England’s MREL policy requires full
subordination of MREL for firms with a bail-in strategy. We can support an outcome which
gives sufficient flexibility for the resolution authority to set an appropriate amount of MREL
and require the subordination of MREL as necessary to implement the resolution strategy.
We are therefore seeking to ensure there is not a material cap on the level of MREL
subordination the resolution authority can require. This issue regarding the level of MREL
subordination is separate to the issue of the UK’s approach to structural subordination,
which was covered in previous correspondence on the Bank Creditor Hierarchy Directive.
We are firmly of the position that firms should comply with MREL requirements as soon as possible. The current text proposes a delay in the deadline for compliance with full MREL requirements until 2024. The Bank of England’s MREL policy statement requires banks to meet full MREL requirements in 2022. We are seeking to ensure resolution authorities can require full MREL requirements to be met earlier than 2024, in line with the Bank of England’s policy.

On MREL eligibility criteria, there continues to be broad support across Member States that amendments to the MREL eligibility criteria should be accompanied by an appropriate grandfathering provision, as noted in my predecessor’s letter dated 23 January 2018. This will ensure that existing MREL issued before a certain date will be continue to be eligible. In addition, we are satisfied that the requirement for MREL to include contractual recognition of bail-in has been removed. The requirement for MREL to include contractual recognition of bail-in is unnecessary and is inconsistent with the broad statutory bail-in power which already exists.

Regarding the introduction of new moratorium powers, which freeze the flow of payment and delivery obligations for a bank, we have made progress to reduce economic and financial stability risks, which the UK has raised concerns about, by limiting the powers. The current text limits a new moratorium power to a maximum of 2 business days from the issuance of a resolution, a position which has been supported by the Single Resolution Board. The resolution authority has the discretion to include deposits in a moratorium. You asked about the positions in Council on the moratorium powers. Some Member States, and industry, have raised economic and financial stability risks alongside the UK, however other Member States have argued for broader moratorium powers to give the authorities more time ahead of a resolution, a position which has been supported by the Single Resolution Board. The Commission has not conducted a cost-benefit analysis for the proposed new powers. We can support an outcome which limits economic and financial stability risks, including the risks to international progress to address the risk of cross-border termination of contracts in resolution, and gives discretion to exempt deposits from a moratorium.

There is broad consensus regarding the proposals to amend requirements for the contractual recognition of bail-in in contracts governed by non-EU law, which addresses industry concerns there may be circumstances where compliance is impracticable. The UK is seeking technical amendments to ensure operability.

If an acceptable compromise is tabled at March ECOFIN I would be grateful if the Committee find themselves able to grant clearance, or waive scrutiny, to enable us to support a General Approach that meets our outlined objectives.

I am writing in similar terms to Lord Boswell of Aynho, Chair of the House of Lords European Union Committee; and copying this letter to Lynn Gardner, Clerk to the Commons Committee; Chris Johnson, Clerk to the Lords Committee; Matthew Manning, Clerk to the Lords Financial Affairs Subcommittee; Les Saunders, Department for Exiting the EU; Frances Milsom and Ross Turner, HM Treasury.
with very best regards

[Signature]

JOHN GLEN
ECONOMIC SECRETARY TO THE TREASURY
Annex- The Commission’s analysis of the EU Intermediate Holding Company requirement

As we have noted previously, the Commission has failed to conduct an impact assessment on the effects of the proposal. However, they provided an analysis in September 2017 which seeks to assess the costs and benefits of the requirement to establish an IHC as proposed by the Commission.

As stated in our previous correspondence, the Commission’s analysis estimates that 35 entities (branches and subsidiaries) based in the UK could be caught by the original Commission proposal. The analysis also estimates that 17 non-EU global systemically important institutions (G-SIs) and two further third country groups would need to establish an EU IHC. Considering the threshold for application (now currently €40bn in the current compromise) of EU assets, 12 of these non-EU G-SIs would be captured under the IHC requirement. This number is based on current third country entities and does not capture any UK banks (as the analysis does not consider the withdrawal of the UK from the EU).

Our preliminary analysis suggests upon the UK’s exit and under a third country status, two UK banks may fall under this requirement. However, this depends on the outcome of negotiations and the UK’s final relationship with the EU, as well as the subsequent restructuring decisions taken by UK banks around any remaining EU operations.