HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

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

8th November 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).

Thank you for your letter dated 11 July 2018. I am writing to provide you and the Committee with an update on the progress of negotiations on bank capital requirements (known as the Risk Reduction Package) where trilogues have commenced.

As you may recall from my previous letter, the Council reached a General Approach in May which achieved the UK's negotiating objectives. My letter also noted that the European Parliament (EP) agreed to their position on the proposal through a vote in June. Under the Austrian presidency, there has been some progress since discussions began on the substance of the package in September. Some technical issues have been agreed on a preliminary basis, but several outstanding issues remain. As is usual during trilogues, the EP text has a number of differences from the Commission and Council texts and negotiations have been focused on where there are conflicting positions. This letter draws your attention to where some of the key differences lie and sets out the UK's priorities for the negotiation.

Banking Recovery and Resolution Directive (BRRD)

The main issue on the BRRD is the framework for setting the EU's Minimum Requirement for Own Funds and Eligible Liabilities (MREL). The UK government supported the Council General Approach on MREL as it broadly met negotiating priorities on flexibility for the resolution authority. The Council gave the Presidency a strong mandate to defend its position in trilogues. The EP text places more limits on resolution authority flexibility.

On subordination, the EP text effectively caps the level at 18% of risk weighted assets, which does not give resolution authorities the flexibility to require a higher level of subordination to deliver the preferred resolution strategy. We believe that it is important that the resolution authority have the flexibility to set the appropriate quantity and quality of MREL and that the Council position achieves this. Other Member States have also indicated their support for maintaining the overall balance of the agreement in the General Approach.

On the overall quantity of MREL, both the EP and Council positions are in line with the international standard on Total Loss-Absorbing Capacity (TLAC). We are satisfied that there is no cap on quantity in either text, with flexibility for the resolution authority to adjust MREL quantity to ensure a bank can command sufficient market confidence following a resolution.

On MREL eligibility criteria, the EP and Council texts both include the language favoured by the UK to address significant industry concerns about new MREL eligibility criteria which would have invalidated existing stocks of MREL. We do not support the EP or Council inclusion of structured notes as eligible for MREL, which is not in line with the TLAC standard. We are continuing to advocate that the EP proposal to empower resolution authorities to disallow structured notes, if they cannot be bailed-in without undue complexity, must be included. We believe a workable compromise in line with our objectives is achievable. On MREL timings, while there is a disagreement on the final deadline for compliance, both texts are aligned in allowing resolution authorities to set an earlier compliance deadline of 1 January 2022, in line with the TLAC standard.

On contractual bail-in clauses, we welcome that both the EP and Council texts reject the Commission's proposal to place the responsibility on the regulator for determining whether it is impracticable to amend a contract to include these clauses. Instead, firms will need to ensure that they comply with requirements. However, we will be opposing the cap of 15% of total liabilities imposed in the EP's report which is arbitrary and unnecessary.

Both texts limit the new moratoria power to two business days. This power can be used by the resolution authority after the 'failing or likely to fail' condition has been met, and can be combined with the existing two-day moratorium tool in BRRD. We will continue to advocate for the deletion of the new moratoria as it is not in line with international standards and is not needed if there is effective cooperation and coordination between the supervisor and resolution authority.

Capital Requirements Directive (CRD) and Capital Requirements Regulation (CRR)

As you know, the package implements several international standards set by the Basel Committee. Both the Council and EP texts largely implement the 3% leverage ratio but differ on its technical calibration. On the requirements for market risk, the Council text puts the EU on the path for full implementation in the future through a reporting requirement, whereas the EP would introduce full capital requirements through this package. On the net stable funding ratio (NSFR), both positions implement a binding 100% NSFR but the EP would give better treatment to certain assets which deviate from the Basel standards. We continue to believe in the importance of harmonisation with international minimum standards set by Basel and will advocate for this.

On the requirement for **intermediate holding companies**, both the Council and European Parliament have introduced measures to enhance the proportionality of this requirement. The focus of the debate is on where the two positions deviate, such as the threshold for the requirement, the inclusion of global systemically important banks below this threshold, and the length of the transition period. We believe that it is important to ensure that the final requirement is proportionate and operable and that the Council position achieves this. Other Member States have also indicated their support to maintain the overall balance of the agreement in the General Approach.

On the issue of **supervisory flexibility**, it is important for us to retain the flexibility in the Council's compromise, where the loss of Pillar 2 tools for macroprudential purposes are appropriately compensated for, as set out in my letter of 28 February. Our concern is that certain aspects of the EP text would limit authorities' ability to tailor their supervisory frameworks to the specific circumstances of their national banking system. In particular, one area of divergence is the design and calibration of the additional capital requirements for other systemically important institutions (O-SIIs), whereby the EP have proposed to set strict levels for additional capital which we believe would be overly prescriptive. It remains important for us to ensure that revisions to the macroprudential toolkit will not compromise supervisors' ability to mitigate financial stability risks. We believe that there is a way towards a workable compromise that aligns with our objective.

On measures of **proportionality**, the EP has introduced measures intended to further support the disapplication of certain requirements to smaller institutions and broadening the capital discounts for banks who lend to infrastructure projects. We recognise the importance of reducing burdens on smaller banks and support this policy. We also acknowledge, along with other Member States, the importance of ensuring that there are no unintended outcomes for financial stability and that the ability to supervise firms are not adversely affected.

As trilogues progress, I will continue to update you on the developments of these negotiations. As previous correspondence has mentioned, there has been a push to reach an agreement by the end of the year and as such, the pace of negotiations could increase rapidly. In the event that an acceptable compromise is reached between the co-legislators, I will provide you with an update on the progress leading up to this and request the Committee to find themselves content to waive scrutiny, or grant clearance, ahead of this.

I am copying this letter to Lord Boswell of Aynho, Chair of the House of Lords European Union Committee; and copying this letter to Foeke Noppert, Clerk to the Commons Committee; Christopher Johnson, Clerk to the Lords Committee; Les Saunders, Department for Exiting the EU; Barbara Armstrong and Daniel Jones, HM Treasury.

JOHN GLEN
ECONOMIC SECRETARY TO THE TREASURY