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European Scrutiny Committee

Banking Reform Report

Fifteenth Report of Session 2017–19

Documents considered by the Committee on 21 February 2018

Report, together with formal minutes

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Notes

Numbering of documents

Three separate numbering systems are used in this Report for European Union documents:

Numbers in brackets are the Committee's own reference numbers.

Numbers in the form "5467/05" are Council of Ministers reference numbers. This system is also used by UK Government Departments, by the House of Commons Vote Office and for proceedings in the House.

Numbers preceded by the letters COM or SEC or JOIN are Commission reference numbers.

Where only a Committee number is given, this usually indicates that no official text is available and the Government has submitted an "unnumbered Explanatory Memorandum" discussing what is likely to be included in the document or covering an unofficial text.

Abbreviations used in the headnotes and footnotes

AFSJ	Area of Freedom Security and Justice
CFSP	Common Foreign and Security Policy
CSDP	Common Security and Defence Policy
ECA	European Court of Auditors
ECB	European Central Bank
EEAS	European External Action Service
EM	Explanatory Memorandum (submitted by the Government to the Committee)*
EP	European Parliament
EU	European Union
JHA	Justice and Home Affairs
OJ	Official Journal of the European Communities
QMV	Qualified majority voting
SEM	Supplementary Explanatory Memorandum
TEU	Treaty on European Union
TFEU	Treaty on the Functioning of the European Union

Euros

Where figures in euros have been converted to pounds sterling, this is normally at the market rate for the last working day of the previous month.

Further information

Documents recommended by the Committee for debate, together with the times of forthcoming debates (where known), are listed in the European Union Documents list, which is published in the House of Commons Vote Bundle each Monday, and is also available on the parliamentary website. Documents awaiting consideration by the Committee are listed in "Remaining Business": www.parliament.uk/escom. The website also contains the Committee's Reports.

*Explanatory Memoranda (EMs) and letters issued by the Ministers can be downloaded from the Cabinet Office website: http://europeanmemoranda.cabinetoffice.gov.uk/.

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Contents

Summary

The EU implemented significant reforms of its legislation governing the banking sector in the aftermath of the financial crisis. It adopted new Directives on capital requirements, deposit guarantee schemes and resolution of failing banks and established centralised supervisory responsibilities within the European Central Bank for the largest credit institutions in the Eurozone as part of its "Banking Union".

In this Report, we have taken stock of the state of play on three sets of draft legislative measures that are currently under discussion at EU level to introduce further regulatory change for the banking sector:

- a set of proposals called the **"Risk Reduction Measures" (RRM) package**, which aims to bring capital requirements for banks in line with new international standards, and improve the prospects for orderly winding-up of failing banks without the need for taxpayer bail-outs. Negotiations on these proposals have taken place since November 2016;

- an **Action Plan on non-performing loans**, which continue to be a drag on bank lending and financial stability in many parts of the EU. The European Commission in January 2018 set out in detail what proposals it will publish this spring to help banks reduce volumes of bad loans on their books; and

- a 2015 proposal to establish a **European Deposit Insurance Scheme (EDIS)** for the Eurozone as part of the "Banking Union", which would in effect share the costs of compensating deposit-holders in case of bank failure among all countries in the single currency area. Progress on this proposal has stalled while the RRM package is finalised.

Of these three, the Risk Reduction Measures package is by far the most significant for the UK. Depending on the timetable for their adoption by the Council and the European Parliament, the new prudential and bank resolution requirements could take effect during the Government's post-Brexit "standstill" period, during which new EU law would still have to be implemented in the UK.

While the Government is broadly supportive of the proposals, especially where they transpose standards by the Basel Committee and the Financial Stability Board into EU law, they also include a new, potentially protectionist, requirement for non-EU banks with operations in the EU to establish independently-capitalised holding companies in the EU. This could have a significant cost impact on British banks who wish to continue operating within the Single Market through subsidiaries after Brexit.

More generally, we share the Treasury Committee's concerns[1] about the Government's inability to provide any concrete detail of its proposals for the post-Brexit UK-EU partnership on financial services, particularly with respect to its desire to establish a legal "process for establishing regulatory requirements for cross-border business between the UK and EU", which the Chancellor referred to in his 2017 Mansion House

1 Treasury Committee, "Economic Secretary refuses to commit to publishing paper on financial services" (8 February 2018).

speech.[2] The Committee takes the view that the EU would make any preferential cross-border access to its market for financial services depend, primarily, on continued alignment of UK and EU financial services regulation.[3]

Throughout the negotiations on the future UK-EU partnership, the Committee will pay particular attention to the balance the Government seeks to strike between UK's post-Brexit regulatory autonomy and any overarching legal obligations vis-à-vis the EU to secure preferential access to the Single Market for financial services. We have retained under scrutiny a number of other EU proposals with direct Brexit implications, including those on the location of clearinghouses,[4] new prudential requirements for investment firms,[5] and the responsibilities of the European Supervisory Authorities vis-à-vis non-EU financial services providers operating within the EU.[6]

The European Scrutiny Committee will continue to report to the House and to the Treasury Committee on the EU-level negotiations on financial services regulation which may have a direct impact on the UK.

2 https://www.gov.uk/government/speeches/mansion-house-2017-speech-by-the-chancellor-of-the-exchequer.

3 For example, the European Commission has reiterated that "free trade agreements offer very limited market access mostly via establishment but not comparable to the Single Market" because they "do not ensure convergence of regulatory frameworks".

4 See our Report of 22 November 2018 on supervision of central counterparties.

5 See Commission document COM(2017) 791. The Committee will publish a Report on this proposal in the coming weeks.

6 See our Reports of 13 December 2017 and of 21 February 2018.

1 Banking reform: risk reduction measures

Committee's assessment	Politically important
Committee's decision	(a), (c) and (d) Not cleared from scrutiny; drawn to the attention of the Treasury Committee; (b) Cleared from scrutiny (decision reported 22 November 2017); (e)-(f) Cleared from scrutiny
Document details	(a) Proposed Directive on loss-absorbing and recapitalisation capacity of credit institutions and investment firms; (b) Proposed Directive on the ranking of unsecured debt instruments in insolvency hierarchy; (c) Proposed Directive as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures; (d) Proposed Regulation concerning aspects of capital requirements; (e) Opinion of the European Central Bank on amendments to the Union framework for capital requirements of credit institutions and investment firms; (f) Opinion of the European Central Bank on revisions to the Union crisis management framework
Legal base	(a)(b)(d) Article 114 TFEU, ordinary legislative procedure, QMV; (c) Article 53(1) TFEU, ordinary legislative procedure, QMV; (e)—(f)—
Department	Treasury
Document Numbers	(a) (38300), 14777/16 + ADDs 1–2, COM(16) 852; (b) (38301), 14778/16 + ADDs 1–2, COM(16) 853; (c) (38303), 14776/16 + ADDs 1–2 COM(16) 854; (d) (38304), 14775/16 + ADDs 1–3, COM(16) 850; (e) (39222), 14388/17; (f) (39223), 14387/17,—

Summary and Committee's conclusions

1.1 Since November 2016 the EU has been discussing a package of complex technical proposals on risk reduction measures (RRM) for the banking sector. These aim to bring the EU's capital requirements for banks in line with international standards, and update its legal framework for the recovery and resolution of failing banks.

1.2 The Committee set out the detail of the RRM package in some detail when we last considered the proposals in November 2017.[7] The Government has been broadly supportive of the package, especially where it incorporates global prudential standards into EU law. In January 2018, the new Economic Secretary to the Treasury (John Glen) wrote to us with an update on the discussions on the proposals between Member States.[8]

7 First Report HC 301–i (2017–19), chapter 19 (13 November 2017).
8 Letter from John Glen to Sir William Cash (23 January 2018).

1.3 The Minister noted that two elements of the proposals which had been fast-tracked, on accounting standards for bank losses and the insolvency hierarchy for bank creditors, had been formally adopted. As we have set out in more detail in "Background" below, in respect of the remaining elements of the RRM package on prudential requirements, the Minister is satisfied that the Member States will support the incorporation of the relevant international standards—for example on market risk, the net stable funding ratio and the leverage ratio—into EU law.

1.4 However, several areas of contention remain:

- the incorporation of the international TLAC standard of "bail-inable" capital for global systemically-important banks into EU law in case they are at risk of collapse;
- the use of moratorium powers by resolution authorities to suspend a failing bank's contractual payment obligations, especially in the "early intervention" phase when a bank might still remain viable; and
- the new requirement for large non-EU banks which have two or more subsidiaries established in the EU to create an intermediate, independently-capitalised EU-based parent undertaking (IPU) to facilitate group supervision and resolution. Given the dominant position of UK banks within the EU's financial system, the European Commission has linked this part of its proposal explicitly to the EU's "preparedness" for Brexit.[9]

1.5 The Minister's letter makes clear the UK is still actively engaging with its EU partners to influence the Council's position on these elements.

1.6 The Bulgarian Presidency of the Council has said it hopes to achieve a General Approach on all remaining elements of the RRM package at the ECOFIN Council on 13 March 2018. The European Parliament's Economic and Monetary Affairs Committee has not yet set a date for its vote on the proposals, but trilogues are expected to take place later this year. Given the extent of the changes proposed, the new legislation is unlikely to be formally adopted until early 2019. It would then take effect in late 2020 or early 2021.

1.7 **We thank the Minister for the detailed update on the state of play on the RRM package within the Council. The Committee has taken note of the fact that, in many areas, the Government expects international standards to be incorporated into EU law and therefore to be in a position to support an eventual Council General Approach.**

1.8 **The Committee also considered the package in the context of the post-Brexit transitional arrangement being sought by the Government. It is now clear that the Government accepts that the UK would continue to apply EU law during this period, including legislation which takes effect only during the transition. In return, it would effectively stay in the Single Market. Although the timetable for adoption of the RRM package is unclear at this stage, so is the potential duration of the transitional arrangement. We therefore consider it possible that the RRM measures will have to be implemented in the UK in full once they agreed between the Council and the European**

9 European Commission presentation on Brexit and services, p. 56 (accessed 6 February 2018).

Parliament. We will keep our conclusions on this point under review as the parameters of the transitional arrangement become clearer, especially as regards its maximum possible duration.

1.9 **After the transition, the impact of the RRM package would be different as the UK would, in principle, only be directly affected by the proposed provisions on "third country" banks. As we noted in our previous Report, this is primarily the requirement for third country banks with a significant presence in the EU (either via subsidiaries or branches) to establish a fully-capitalised intermediate parent undertaking (IPU) in an EU country. The European Commission has explicitly tied this part of its proposals to the perceived need to retain a level of EU oversight of UK banks operating within the Single Market, even after Brexit.**[10]

1.10 **In his latest letter, the Minister notes that the IPU proposal may lead to protectionism and regulatory fragmentation, especially if it could—as suggested by the European Central Bank—also be triggered by the presence of simple branches in addition to fully-capitalised subsidiaries. Following Brexit, it could mean higher costs for UK-headquartered banks with a presence in EU countries: once the UK leaves the Single Market, subsidiaries and entities of UK banks will count towards triggering the IPU requirement as they will be considered part of a "third country" undertaking. In turn, this means larger UK banks may have to establish a new, fully-capitalised IPU in an EU Member State to continue operating through its branches and subsidiaries.**

1.11 **We accept, as the Minister says, that the full impact of the IPU measure will depend on both the outcome of the legislative process, and on the substance of any UK-EU financial services agreement. However, we are concerned by the European Commission's explicit linking of its proposals in this area to the EU financial sector's "preparedness" for Brexit, which indicates UK banks with a presence in the EU are being targeted specifically by this new requirement.**

1.12 **We will press the Minister for further analysis as the negotiations progress, especially with respect to the number of UK banks potentially affected; the costs they may incur; and the extent to which it may trigger relocation of banking operations from the UK to the EU. We take the view that the possibility of any exemptions for UK banks from being considered "third country" undertakings under the IPU proposal—or EU financial services law more generally—after the UK leaves the Single Market will depend, primarily, on the level of continued regulatory alignment in financial services between the UK and the EU.**

1.13 **Given the political importance of these proposals for the financial services industry, we ask the Minister to inform the Committee in good time of the substance of any Council's General Approach or mandate for trilogues. In the meantime, we retain the outstanding legislative proposals under scrutiny, and draw these developments to the attention of the Treasury Committee. We are content to clear the Opinions of the European Central Bank from scrutiny.**

10 European Commission Article 50 Task Force, Presentation on Services and EU-UK relations after Brexit, p. 56 (February 2018). This includes, under the heading "Preparedness: Adaptations of EU law".

Full details of the documents

(a) Proposed Directive amending Directive 2014/59/EU on loss-absorbing and recapitalisation capacity of credit institutions and investment firms and amending Directive 98/26/EC, Directive 2002/47/EC, Directive 2012/30/EU, Directive 2011/35/EU, Directive 2005/56/EC, Directive 2004/25/EC and Directive 2007/36/EC: (38300), 14777/16 + ADDs 1–2, COM(16) 852; (b) Proposed Directive on amending Directive 2014/59/EU of the European Parliament and of the Council as regards the ranking of unsecured debt instruments in insolvency hierarchy: (38301), 14778/16 + ADDs 1–2, COM(16) 853; (c) Proposed Directive amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures: (38303), 14776/16 + ADDs 1–2, COM(16) 854; (d) Proposed Regulation amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements and amending Regulation (EU) No 648/2012: (38304), 14775/16 + ADDs 1–3, COM(16) 850; (e) Opinion of the European Central Bank of 8 November 2017 on amendments to the Union framework for capital requirements of credit institutions and investment firms: (39222), 14388/17,—; (f) Opinion of the European Central Bank of 8 November 2017 on revisions to the Union crisis management framework: (39223), 14387/17,—.

Background

1.14 The European Commission in November 2016 tabled a package of legislative proposals to further reduce risk in the EU's financial system (referred to as the Risk Reduction Measures or RRM). The proposals aim to bring the EU's existing legislation in line with new international standards to safeguard the stability of the banking system.

1.15 These interrelated proposals, collectively referred to as the "Risk Reduction Measures" (RRM), would affect many key pieces of EU financial regulation, including the Capital Requirements Directive and Regulation, and the Bank Recovery and Resolution Directive. The objectives of the RRM package can be split into prudential aspects (intended to prevent banks from needing a bail-in or bail-out) on the hand, and recovery and resolution aspects (which apply if a bank, notwithstanding the prudential requirements, is in financial difficulty) on the other.

Prudential requirements

1.16 The proposed new prudential requirements for banks under the RRM package would:

- establish a legally-binding **leverage ratio** which will prevent banks from excessively increasing their debt levels, for example to compensate for low profitability;
- introduce a binding **net stable funding ratio** (NSFR) which will establish a harmonised standard for how much stable, long-term sources of funding a financial institution needs in order to weather periods of market and funding stress. The NSFR is calculated as the ratio of an institution's amount of available stable funding (ASF) to its amount of required stable funding (RSF);

- **reduce market risk** by establishing more risk-sensitive "own funds" prudential requirements for institutions that have substantial exposure to securities and derivatives;
- amend the rules relating to firm-specific additional prudential requirements (so-called **Pillar 2 requirements**) to set out the options for competent authorities to impose additional own funds requirements, to reduce diversity in application with the intent of achieving greater harmonisation across the EU; and
- require non-EU banks with subsidiaries in multiple EU countries to establish an **Intermediate Holding Company** within the Single Market to facilitate any resolution efforts.

Bank recovery and resolution

1.17 The proposals would amend the Bank Resolution & Recovery Directive (BRRD) to:

- impose new standards on the **total loss-absorbing capacity (TLAC) of global systemically important banks**, which will require those institutions to have more loss-absorbing and recapitalisation capacity in the event they are at risk of collapsing and require resolution;
- restrict rules that require banks to include **recognition of the EU's bail-in powers** when they enter into contracts not governed by EU law,[11] and introduce new **pre-resolution moratorium powers** to freeze the flow of payment and delivery obligations for a short period of time (subject to exceptions, including covered deposits); and
- implement a **new accounting standard on calculating banking losses** and rules on **creditor hierarchy in the event of bank failure**; these two proposals were fast-tracked and have already been adopted (see paragraph 1.24).

Related policy initiatives

1.18 In addition to the RRM proposals to reduce potential sources of financial instability in the banking sector, the EU is also taking steps to reduce the overall amount of 'bad loans' on banks' books and to increase the protection offered by deposit guarantee schemes.

1.19 Non-performing loans (NPLs), which were estimated to total €1 trillion (£887 billion)[12] of outstanding bank loans at the end of 2016,[13] are loans subject to late repayment or which are unlikely to be repaid without requiring the sale of collateral. They reduce banks' capital and thereby affect their ability to lend or to absorb other shocks to their liquidity, in turn potentially hampering economic growth. EU Finance Ministers called for

11 Article 55 of the BRRD requires firms to include a clause in a large number of contracts governed by non-EEA law, acknowledging that the contract may be subject to the bail-in powers of the EU resolution authority. This requirement currently has a very broad scope, leading banks to raise concerns that it was "extremely difficult and costly to implement and extends to contracts which would be unlikely to be bailed-in". The Commission proposal amends Article 55 so that it need not apply in instances of "legal, contractual and economic impracticability".

12 €1 = £0.88723 or £1 = €1.12710 as at 29 December.

13 http://data.consilium.europa.eu/doc/document/ST-9854–2017-INIT/en/pdf/.

several EU-level initiatives to further reduce risks within the banking sector by tackling non-performing loans (NPLs) within European banks in July 2017.[14] In early 2018, the Commission published an update on progress made.

1.20 In addition to the RRM and NPL package, the Commission also continues to support its 2015 proposal for a European Deposit Insurance Scheme (EDIS), which would gradually mutualise the Eurozone's national deposit protection schemes. Negotiations on this proposal are effectively on hold while the risk reduction measures for the banking sector are established.

1.21 We have considered both the Non-Performing Loans Action Plan and the proposal for a European Deposit Insurance Scheme in other chapters of this Report.

RRM package: Developments since November 2017

1.22 The Committee last considered the RRM package at our meeting on 13 November 2017.[15] That same month, the European Central Bank published two broadly favourable Opinions on the RRM package (documents E and F). Especially important in the context of the UK's withdrawal from the EU are the changes the ECB proposed to the requirement for certain non-EU banks to establish Intermediate Parent Undertakings in the EU (see paragraphs 1.34 to 1.41).

1.23 On 29 November 2017 EU Finance Ministers considered the state of play on the RRM package, based on a report prepared by the Estonian Presidency.[16] The new Economic Secretary to the Treasury (John Glen) wrote to us with an update on consideration of the proposals on 23 January 2018.[17] In summary, the state of play on the proposals within the Council is as follows:

Bank creditor hierarchy and IFRS9

1.24 The fast-tracked proposals on the implementation of the IFRS9 standard[18] and subordination in the bank creditor hierarchy[19] were both agreed between the Council and the European Parliament in November 2017. They have since been published in the Official Journal, and will apply from January 2018 and December 2018 respectively.

1.25 The Government supported the Bank Creditor Hierarchy Directive, which will make little practical difference in the UK as it does not prevent the Bank of England from using its preferred approach of structural subordination.[20] However, the Minister explained that the Government had abstained in the vote on the IFRS9 proposal because it remained under scrutiny in the House of Lords.

14 https://www.consilium.europa.eu/en/press/press-releases/2017/07/11/banking-action-plan-non-performing-loans.
15 First Report HC 301–i (2017–19), chapter 19 (13 November 2017).
16 Progress Report by the Estonian Presidency (Council document 14896/17).
17 Letter from John Glen to Sir William Cash (23 January 2018).
18 Regulation 2017/2395 as regards transitional arrangements for mitigating the impact of the introduction of IFRS 9 on own funds.
19 Directive 2017/2399 as regards the ranking of unsecured debt instruments in insolvency hierarchy.
20 Under structural subordination, group structures are used to ensure that debt issued to external investors is subordinate in the event of insolvency. An investor lends money to a holding company, which in turn lends it to one of its operating subsidiaries. If insolvency occurs, the investor cannot access the assets of these subsidiaries until all the creditors of the subsidiaries have been paid.

Prudential requirements for banks

Leverage ratio

1.26 The Member States support the introduction of the international standard of a three per cent leverage ratio for banks into EU law, but will finalise the technical aspects of this element in the coming months. This is in line with Government policy as set out in its original Explanatory Memorandum in December 2016.

Pillar 2 prudential requirements

1.27 With respect to the ability of Member State authorities to impose additional prudential requirements beyond the statutory minimum (so-called Pillar 2 requirements),[21] the Council wants to increase the flexibility granted to the domestic regulators compared to the original Commission proposal.[22]

1.28 The Government's position is that national regulators should retain the ability to use macroprudential Pillar 2 tools. In his latest letter, the Minister notes that he has "successfully pushed for more flexibility for national supervisors to compensate for the removal of pillar 2 measures from macroprudential use". The Government will continue to argue for a legal text that does not "materially impair the Financial Policy Committee's ability to promote and enhance UK financial stability".

1.29 However, there is no consensus yet about the level of the capital buffer for "other systemically important institutions" (O-SII).[23] O-SII banks are institutions that are not considered systemically important at international level, but are systemically important within the banking system of an individual EU country. They are subject to specific additional capital requirements, which is capped under EU law. The Council is considering increasing this cap so that Member States have more flexibility to impose higher prudential requirements where considered necessary.

Market risk

1.30 The Commission proposals contain new rules for the use of banks' internal models to quantify "own funds" requirements[24] to compensate market risk related to exposure

21 Under the current Capital Requirements Directive, the Pillar 2 framework is a set of provisions that give competent authorities the discretion to impose additional capital requirements and other precautionary measures where, in the authorities' assessment, statutory prudential requirements fail to capture (in full or in part) certain risks of a bank or the sector as a whole. The Commission had proposed to remove the ability of regulators to impose macro-prudential pillar 2 requirements, limiting their competences only to micro-prudential (i.e. firm-specific) pillar 2 interventions.

22 The Commission had wanted to remove the ability for Member States to use the Pillar 2 capital add-ons for macroprudential reasons, arguing that they are meant to be "institution-specific measures that should be used to address risks to which an institution is exposed".

23 Member States also expressed concerns about the proposal to exempt Germany's 16 regional promotional banks (RPBs) from the CRD. The Estonian Presidency therefore suggested applying the exemption only to those RPBs with assets of less than €30 billion (£26 billion).

24 "Own funds" refers to are funds available to a bank that allows it to absorb losses in a going or in a gone concern situation. The Capital Requirements Regulation (CRR) sets out the characteristics and conditions for own funds, backed up by further regulatory technical standards developed by the European Banking Authority. See also the section on "MREL" elsewhere in this chapter.

to securities and derivatives. The Government has worked with "like-minded Member States" to restrict how far the amendments to the CRD deviate from the Basel Committee's standards on the same subject.[25]

1.31 The Government has previously stated that full implementation of the new standard has been hindered by work within the Basel Committee on revaluating its impact, as well as statements from the US that it is considering delaying implementation. However, in his latest letter, the Economic Secretary expresses his confidence that the Basel Committee's standards will be introduced into the EU's capital requirements legislation "in an appropriate fashion".

Net Stable Funding Ratio

1.32 Member States continue to discuss a mutually acceptable way to proceed on the net stable funding ratio, the amount of stable, long-term sources of funding a bank needs in order to weather periods of market and funding stress.

1.33 The Government has previously explained that there are divergent views within the Council on "deviating from, or pre-empting" decisions taken by the Basel Committee on this topic, but the Minister now writes that he "expect[s] an outcome that will be broadly consistent with Basel".

Intermediate Parent Undertakings

1.34 The Commission proposed a new requirement under the Capital Requirements Directive for non-EU banks which have two or more subsidiaries established in the EU. They would have to create an intermediate, independently-capitalised EU-based parent undertaking (IPU)—constituted as either a credit institution or a financial holding company—to facilitate group supervision and the application of prudential standards. Given the dominant position of UK banks within the EU's financial system, the European Commission has linked this part of its proposal explicitly to the EU's "preparedness" for Brexit.[26]

1.35 As proposed by the Commission, this requirement would apply to:

- third-country banking groups that are non-EU global systemically-important banks with two or more subsidiaries in the EU (whatever their assets); and
- third-country banking groups which have two or more subsidiaries in the EU, where the total assets it holds within the EU—in both subsidiaries *and* branches[27]—exceed €30 billion (£27 billion).[28]

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25 See https://www.bis.org/list/bcbs/tid_137/index.htm.

26 European Commission presentation on Brexit and services, p. 56 (accessed 6 February 2018).

27 Under the Capital Requirements Regulation, a "subsidiary" is an independently-capitalised credit institution, authorised by the regulator of an EU Member State, which is owned by a larger undertaking. A "branch" is a place of business which is authorised by an EU regulator, but which has no independent legal personality and forms a legally dependent part of a credit institution. There is no general right ("passporting") for non-EU banks to establish branches within the EU, but individual Member States can permit this under domestic law.

28 The calculation of total assets would include both subsidiaries and branches of those third-country groups within the EU.

1.36 The European Central Bank has also suggested that the requirement should be triggered not only by the number of subsidiaries but also by the number of branches operated by a non-EU bank within the EU.[29] Moreover, once an intermediate EU parent undertaking is established, the ECB proposes that it should be a "requirement that the existing branches of the same third-country banking group exceeding a certain threshold are re-established as branches of a credit institution authorised in the Union to prevent regulatory arbitrage opportunities".[30]

1.37 Within the Council, the Government—supported by Luxembourg—has opposed the IPU provisions as drafted because it takes the view that the impact was uncosted and its benefits for the supervisory process unclear. The Minister has said that the proposal would lead to "initial restructuring costs as well as additional on-going governance, reporting and disclosure costs for firms", and disputes the Commission's assertion that the proposal would "not necessarily lead to additional capital and liquidity requirements".

1.38 The UK also opposes the amendments proposed by the ECB with respect to EU-based branches of non-EU banking groups. The Minister notes that these would effectively force full subsidiarisation, "as third country banks [subject to the IPU requirement] would no longer be able to branch into the EU". Instead, they would have to be restructured as the branch of a bank fully authorised and capitalised within the EU, reducing the flexibility of individual EU countries to permit third country branches to operate on their territory. This, he says, would represent a "significant degree of protectionism" which could trigger similar measures elsewhere in the world, leading to "further global regulatory fragmentation".

1.39 It is unclear to what extent the IPU proposals, including the ECB's suggested amendments, have the support of other EU countries. The Minister notes that "some Member States" want to bring branches into the scope of the IPU requirement. However, an unspecified number of other EU countries have supported the UK's efforts to make the IPU element more proportional, for example by increasing the threshold of application; removing some undertakings from its scope; and by allowing "more efficient structures" to be used. In addition, the latest publicly-available Presidency compromise text for the proposal has removed the IPU requirement for non-EU G-SIIs which do not have assets of at least €30 billion in their EU subsidiaries and branches.[31] However, the ECB's proposals had not yet been considered in detail at that point.

1.40 Under the original Commission proposal, 35 UK-based offshoots of non-EU, non-UK banks—both subsidiaries and branches—would have had to be made subordinate to an intermediate parent company. In his latest letter, the Minister explains that the full impact of the IPU measure will be "highly dependent" on both the final legal text and any agreement between the UK and EU on financial services after Brexit. In particular, UK-based subsidiaries and branches will presumably no longer count towards the IPU requirement after the UK leaves the Single Market. Conversely however, EU-based

29 See footnote 17.

30 European Central Bank Opinion on amendments to the Union framework for capital requirements of credit institutions and investment firms (8 November 2017).

31 Council document 14892/17.

branches and subsidiaries of UK banking groups *would* be caught, potentially increasing the cost of providing financial services to EU-based customers from the UK through a branch or subsidiary.[32]

1.41 However, the Minister says in his letter of 23 January 2018 that the Government expects "to be able to support the final outcome" of the negotiations on the IPU proposal "in the interest of an overall deal" on the RRM package.

Bank Recovery and Resolution

Minimum Requirement for own funds and Eligible Liabilities (MREL)

1.42 The underlying objective of the 2014 Bank Recovery and Resolution Directive is that the cost of bank failures should be borne primarily by shareholders and creditors (a "bail-in"), not taxpayers (a "bail-out").

1.43 The Directive therefore established the "Minimum Requirement for own funds and Eligible Liabilities" (MREL).[33] This requires national resolution authorities to fix a firm-specific level of liabilities that can be readily "bailed-in", such as deposits, to absorb losses based on their firm-specific risk profile, while also remaining compliant with the prudential requirements that underpin their authorisation. MREL applies to any bank authorised by an EU financial regulator, but there is no minimum "floor" that must be used for all institutions.

1.44 Separately however, the Financial Stability Board (FSB) developed the international Total Loss-Absorption Capacity (TLAC). This sets an 18 per cent minimum proportion of the risk-weighted assets of global systemically-important banks ("G-SIIs") that must be readily bail-inable in the event of bank failure. As TLAC and MERL have the same regulatory objective, the Commission proposed to incorporate the TLAC standard into EU law by requiring EU-based G-SIIs[34] to hold a statutory (Pillar 1) minimum MREL equivalent to the TLAC standard. It would also allow national resolution authorities to impose firm-specific additional (Pillar 2) MREL requirements on G-SIIs. The existing MREL requirements for other (smaller) banks would remain substantially the same.[35]

1.45 The Minister notes that "several challenges remain" in the negotiations over the TLAC and MERL requirements for systemically-important banks. In particular, he says that the Government "continues to advocate full implementation of the FSB's TLAC standard", while some Member States want to "weaken the standard". In addition, some EU countries want to extend the TLAC statutory minimum requirement to large European banks

32 The four UK-based G-SIIs (Barclays, HSBC, Royal Bank of Scotland and Standard Chartered) will become non-EU banks when the UK leaves the Single Market. They may have to establish an IPU within the EU if they have at least two branches or subsidiaries in EU countries that hold assets exceeding €30 billion.

33 Article 45 of Directive 2014/59/EU.

34 The twelve G-SIBs based in the EU as of November 2017 are BNP Paribas, Crédit Agricole and Société Générale (France); Deutsche Bank (Germany); Unicredit (Italy); ING (the Netherlands); Santander (Spain); Nordea (Sweden); and Barclays, HSBC, Royal Bank of Scotland and Standard Chartered (UK).

35 The Commission proposal would make "appropriate technical amendments" to the existing MREL for non-G-SIBs, in order to " align them with the TLAC standard as regards inter alia the denominators used for measuring loss-absorbing capacity, the interaction with capital buffer requirements, disclosure of risks to investors and their application in relation to different resolution strategies".

which are not classified as G-SIBs.[36] The Minister reiterated—as his predecessor did in June 2017—that there remains "broad support" for the grandfathering of banks' MREL stocks based on existing rules to prevent these from being invalidated by the new rules.

Pre-resolution moratoria

1.46 In the RRM package, the Commission proposed a new moratorium tool allowing resolution authorities to suspend the payment obligations of a failing bank for a short period of time during both the early intervention phase (when a bank might still recover) and during resolution (when it is no longer viable). The rationale is that such a moratorium allows the authorities to evaluate the bank's assets and liabilities, and implement an appropriate resolution strategy. The moratorium would not apply to deposit-holders wishing to withdraw deposits covered by their national Deposit Guarantee Scheme.

1.47 The Government has consistently opposed this element of the proposal. The UK's position is that an extended moratorium could have a significant economic impact and "risks undoing international progress to address the risk of cross-border termination of contracts in resolution", such as the Universal Stay Protocol elaborated by the Financial Stability Board.[37]

Remuneration in the banking sector

1.48 The Commission proposed to lift some of the EU's rules on remuneration for bankers, relating to deferral of bonuses and pay-out in instruments, for companies with less than €5 billion (£4.5 billion) in assets or for staff in any firm with relatively low bonus payments. Individual Member States would retain the flexibility to impose the full restrictions if they so choose.

1.49 In June 2017 the then-Economic Secretary explained that the proposal would reduce flexibility for the use of tools to incentivise good conduct, such as payment in instruments and deferred remuneration, and the UK had therefore secured support within the Council for the retention of the status quo. This is confirmed by his successor's latest letter.[38]

Next steps

1.50 The Bulgarian Presidency of the Council has said it hopes to achieve a general approach on all remaining elements of the RRM package at the ECOFIN Council on 13 March 2018. The European Parliament's Economic and Monetary Affairs Committee has not yet set a date for its vote on the proposals, but trilogues are expected to take place later this year.

1.51 The Government has previously stated that, given the extent of the changes proposed, it does not expect the new legislation to be formally adopted until early 2019. If that timetable is adhered to, the changes to the EU's capital requirements and bank recovery legislation would then take effect in late 2020. Depending on the timing of the adoption

36 These are the "other systemically important institutions" ("O-SIIs"), as listed by the European Banking Authority.

37 See e.g. https://www.isda.org/a/GkiDE/a-step-backwards-in-efforts-to-end-too-big-to-fail-final-002.pdf.

38 The so-called "bonus cap", which limits bankers' bonuses to 200 per cent of their fixed salary, would not be affected by this new exemption.

of the proposals, and the length of the UK's post-Brexit transitional arrangement during which it remains bound by EU law, the new rules may therefore have to be applied in the UK in full.

Previous Committee Reports

Thirty-second Report HC 71–xxx (2016–17), chapter 6 (22 February 2017); Twenty-fifth Report HC 71–xxiii (2016–17), chapter 6 (11 January 2017); and First Report HC 301–i (2017–19), chapter 19 (13 November 2017).

2 European Deposit Insurance Scheme (EDIS)

Committee's assessment	Politically important
Committee's decision	Not cleared from scrutiny
Document details	Proposal for a Regulation to establish a European Deposit Insurance Scheme
Legal base	Article 114 TFEU; ordinary legislative procedure; QMV
Department	Treasury
Document Number	(37332), 14649/15, COM(2015) 586

Summary and Committee's conclusions

2.1 In November 2015 the European Commission tabled a Regulation[39] to create a European Deposit Insurance Scheme (EDIS) within the EU's Banking Union, which currently consists only of the Eurozone countries.[40] The EDIS, as originally proposed, would eventually mutualise all deposit liabilities across the Banking Union into a single deposit guarantee scheme. This, the Commission argues, would prevent a large local banking crisis from overwhelming the national deposit guarantee scheme (DGS) of a Member State. The scheme would be funded by direct contributions from banks.

2.2 The Government does not consider that the proposal has any direct impact on the UK, given that it does not participate in the Banking Union and will therefore not be covered by the EDIS, should it be established.[41]

2.3 In January 2018 the then-Economic Secretary to the Treasury (Stephen Barclay) wrote to the Committee with an update on the negotiations on the proposed scheme.[42] The Minister's letter confirms that negotiations over the proposal remain protracted, and that there is no agreed position among the Member States on key elements of the draft legislation (the sharing of the cost of compensating deposit-holders in the event of a bank failure). A number of Eurozone countries, led by Germany, are of the view that a parallel package of measures to *reduce* the risks of a crisis in the EU's banking sector need to be agreed before any mutualisation of the costs of such a crisis would be shared.[43] To break this deadlock, the Commission suggested in October 2017 that the proposal could be modified to stop short of full mutualisation of national DGS.[44]

39 See Commission document COM(2015) 586.
40 Participation in the Banking Union is mandatory for Eurozone countries and optional for other EU Member States. At present, no non-Eurozone EU countries participate. The existing pillars of the Banking Union are the Single Supervisory Mechanism and the Single Resolution Mechanism for failing banks. See the "Background" section for more information.
41 Explanatory Memorandum submitted by HM Treasury (10 December 2015).
42 Letter from Stephen Barclay to Sir William Cash (8 January 2018).
43 The so-called Risk Reduction Measures (RRM) package, which would apply to all EU countries (not just the Eurozone). The Committee considered the implications of the package in its Report of 13 November 2017.
44 See paragraph 3.21 for more information on the new Commission approach.

2.4 Although the political element of the proposal is effectively on ice, Eurozone countries have continued discussing the technical aspects of the proposal, including the methodology for calculating banks' contribution to the EDIS. The current Bulgarian Presidency of the Council is expected to continue facilitating discussions on the EDIS at a technical level in the coming months, but no agreement is foreseen in the first half of 2018.

2.5 **We thank the Minister for the information on the state of play on the EDIS. Given that the UK will not be part of the mutualised deposit guarantee scheme irrespective of Brexit, and negotiations on the proposal have not progressed substantially, no immediate issues arise that would affect the UK's interests.**

2.6 **However, we retain the draft Regulation under scrutiny given its importance within the wider EU Banking Union, which may influence the future of EU financial services legislation and, by extension, have an impact on the substance and scope of a financial services agreement between the UK and the EU after Brexit. We also note the possibility that branches of UK banks within the Eurozone may have to make a financial contribution to the EDIS, if and when it is established.**

Full details of the documents

Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 806/2014 in order to establish a European Deposit Insurance Scheme: (37332), 14649/15, COM(2015) 586.

Background

2.7 Following the financial crisis, the EU introduced a 'Single Rulebook' for the banking sector. This is EU legislation that applies to all credit institutions and across the EU. The primary legislative acts of the rulebook are the 4th Capital Requirements Package (CRD 4);[45] the Deposit Guarantee Schemes Directive (DGSD);[46] and the Bank Recovery and Resolution Directive (BRRD).[47]

2.8 In addition to efforts to reinforce the economic governance of the Eurozone to make its public finances sustainable, the European Commission also launched a drive towards the creation of a Banking Union. The purpose of the Banking Union is to apply the Single Rulebook in the most uniform way possible, with the aim of making the banking sector more secure and preventing any future needs for taxpayer-funded bail-outs. Participation in the Banking Union is mandatory for Eurozone countries and voluntary for other EU Member States. At present, no non-Eurozone country participates, although both Denmark and Sweden are considering joining.

2.9 The Banking Union currently consists of two pillars:

- firstly, a Single Supervisory Mechanism (SSM), which monitors the prudential health of banks in participating countries under CRD 4. The SSM is the EU's supranational bank supervisory body, where responsibility for supervising the largest financial institutions is exercised directly by the European Central Bank

45 Directive 2013/36/EU and Regulation (EU) 575/2013 on capital requirements for credit institutions.
46 Directive 2014/49/EU on deposit guarantee schemes.
47 Directive 2014/59/EU on the recovery and resolution of credit institutions.

in close cooperation with national supervisory authorities.[48] A review by the European Commission in October 2017 concluded that the Mechanism was working effectively.[49]

- secondly, a Single Resolution Mechanism (SRM) for the application of the BRRD to failing banks in the participating countries. The SRM is a system for the resolution of failing banks. It consists of a central resolution authority (the Single Resolution Board) and a Single Resolution Fund (SRF).[50] The latter provides financial assistance to resolution proceedings of failing banks, for example by purchase some of its assets or to compensate creditors.[51]

The proposal for a European Deposit Insurance Scheme

2.10 In November 2015 the Commission tabled a Regulation for a third pillar of the Banking Union: a European Deposit Insurance Scheme (EDIS).[52] The EDIS, as originally proposed, would eventually mutualise all deposit liabilities across the Banking Union into a single deposit guarantee scheme. The scheme is to be introduced by amendment of the Single Resolution Mechanism Regulation.[53]

2.11 The rationale behind mutualisation of national deposit schemes is that the current system of national Deposit Guarantee Schemes (DGS) remains vulnerable to large local shocks, and that a common deposit insurance scheme would "increase the resilience of the Banking Union against future crises". The impact of a large bank failure in one participating country would be cushioned by the fact that its depositors were protected by a larger guarantee scheme, reducing the risks of a run on deposits. As the Commission argued:

> "The analysis indicates that the number and size of banks for which the Deposit Insurance Fund could handle pay-outs increases significantly for all Member States under EDIS compared to national DGSs."

2.12 Under the original Commission proposal, the EDIS would become operational in three distinct phases:

- in the first three years it would be based on a reinsurance model.[54] During this time, a new Deposit Insurance Fund (DIF) would be created, funded by the national Deposit Guarantee Schemes of the participating Member States. Risk-sharing would be limited; the DIF would provide liquidity assistance to a participating DGS if the latter's own funds were exhausted by the failure of a bank within its remit, but mostly in the form of repayable loans;[55]

48 Council Regulation (EU) 1024/2013 on the tasks of the European Central Bank relating to the prudential supervision of credit institutions.
49 European Commission document COM(2017) 591.
50 Council Regulation (EU) 2014/806 on a Single Resolution Mechanism and a Single Resolution Fund.
51 The SRF is meant to achieve a coverage of €55 billion by 2024, funded by contributions from the Eurozone banking sector.
52 European Commission document COM(2015) 586.
53 See footnote 12.
54 Reinsurance is the practice whereby insurers transfer some of the risks of their balance sheets to another organisation, with the aim of avoiding becoming fully liable for paying out large insurance claim.
55 During the first phase of the DIF, as proposed by the Commission, the Fund could absorb some (limited) losses from providing liquidity assistance to a national Deposit Guarantee Scheme.

- in the second phase, which would last for four years, the EDIS would become a co-insurance model, with increased amounts of risk-sharing. National DGS could access liquidity support before they exhausted their own funds, and the DIF would share a progressively larger proportion of any losses (but never the full amount);[56] and

- After this phase the EDIS would be fully mutualised. National deposit guarantee schemes would be fully insured through the DIF, which would fully cover losses in the event of a resolution procedure or pay-out if a covered bank were to fail.

2.13 A national DGS would only benefit from EDIS if its funds are being built up in line with a precise funding path and it otherwise complies with essential requirements under EU law. Contributions into the Deposit Insurance Fund would be made by banks directly using a risk-based methodology, allowing Member States to reduce contributions to their national DGS commensurately. The methodology to calculate each institution's payments would be set by the Commission, with the support of a qualified majority of Member States, via a Delegated Act.

2.14 The Single Resolution Board, which would be expanded to administer the EDIS, would monitor national DGSs and release funds only where clearly defined conditions are met.

Consideration of the EDIS proposal in the Council

2.15 The then-Economic Secretary to the Treasury (Harriett Baldwin) submitted an Explanatory Memorandum on the proposal on 10 December 2015.[57] It noted that, as the UK is not in the Banking Union, the EDIS would have no direct impact on the Financial Services Compensation Scheme's deposit guarantee mechanism.

2.16 However, the proposal has divided the Eurozone countries which it would affect directly. Some Member States—notably Germany—are concerned it creates a 'moral hazard' by reducing the incentive for participating countries to make their banking sectors safer, as the cost of compensating citizens for lost deposits would be borne by all Eurozone countries.[58] As a result, there is no consensus between Eurozone countries about the appropriate level of risk-sharing in the final phase of the EDIS.

2.17 Shortly after the Commission issued its proposal, Member States called for the methodology for calculation contributions into the Deposit Insurance Fund to be set down in the text of the ESID Regulation itself, and not be left for a decision by the Commission through a Delegated Act. There is also some controversy about the use of Article 114 TFEU, on the internal market, as the legal basis for the proposal.[59]

2.18 In June 2016, EU Finance Ministers considered the future of the Banking Union, and called on the European Commission to table further legislative proposals to strengthen the prudential resilience of the EU's banking sector, and reduce the risk of bank failure.[60]

56 The losses of a deposit guarantee pay-out are calculated by subtracting the total amount of covered deposits of the failing bank by the proceeds from the insolvency estate acquired by the national Deposit Guarantee Scheme.

57 Explanatory Memorandum submitted by HM Treasury (10 December 2015).

58 *Financial Times*, "Germany stands firm against EU bank deposit guarantee plan" (17 October 2017).

59 Letter from Simon Kirby to Sir William Cash (17 August 2016).

60 ECOFIN Council, "Council Conclusions on a roadmap to complete the Banking Union" (17 June 2016).

They also agreed that political negotiations on the risk sharing elements of the deposit insurance proposal—i.e. the absorption of losses by a national deposit guarantee scheme by the communally-funded EDIS—would only start when “sufficient further progress” had been made on those risk reduction measures (RRM). These latter proposals were published by the European Commission in November 2016 and are still under discussion. We have considered the state of play of the RRM package elsewhere in this Report.[61]

2.19 The European Scrutiny Committee last considered the EDIS proposal in September 2016, retaining it under scrutiny.[62]

Developments since September 2016

2.20 Technical negotiations at Working Party level continued within the Council throughout 2017. However, in view of the on-going discussions on the RRM package, no substantive progress was made towards adoption of the proposal.

2.21 In October 2017 recognising the barriers to adoption of the EDIS Regulation, the Commission proposed a less ambitious approach for the Council to take in its consideration of the proposal. In particular, the Commission suggested that the DIF could provide only liquidity assistance but no loss absorption in the first stage (meaning no risk-sharing); there would be a conditionality test before the EDIS moved to the co-insurance phase; and there would be no full mutualisation after seven years.

2.22 On the basis of the Commission’s suggestions and a progress report prepared by the Estonian Presidency, EU Finance Ministers considered the EDIS proposal at their meeting on 5 December 2017.[63] On 8 January 2018 the then-Economic Secretary (Stephen Barclay) wrote to the Committee with an update on the status of the negotiations at this meeting. He noted that the technical discussions within the Council had continued to focus on:

- the development of a risk-based contribution methodology which calculates the contributions of each country to the Deposit Insurance Fund in proportion to the size of their banking sector and the estimated risk of a bank failure;
- the alternative measures which could apply to credit institutions that go into insolvency proceedings to prevent the need to compensate deposit-holders;
- the inclusion within (and therefore contributions to) the EDIS of EU-based branches of banks headquartered outside the European Union;[64]
- the inclusion within the EDIS of deposit-taking entities that are currently excluded from the Single Resolution Mechanism and Single Supervisory Mechanism but are covered by an existing national deposit guarantee scheme (DGS);[65]

61 The RRM package, which we have considered in more detail in chapter [x] of this Report, consists of six separate legislative texts. Two of those were adopted towards the end of 2017; the other four remain subject to detailed negotiations within the Council and the European Parliament.

62 See Committee Report of 7 September 2016.

63 See Council document 14808/17.

64 Under the Deposit Guarantee Scheme Directive, individual Member States have the discretion to require a third-country branch (including those of UK-based banks after the UK leaves the Single Market) to join a national DGS if the third country protection is not considered as equivalent. Some Member States are concerned that excluding these from the EDIS would create a two-tier system of deposit protection, with deposits held by banks covered by ESID benefitting from more protection than those held by banks outside of its scope.

65 The Commission’s proposal stipulates that EDIS should apply to all banks affiliated to a national DGS, meaning it would also cover financial institutions that fall outside the scope of the other pillars of the Banking Union because they are not covered by the Capital Requirements Directive (CRD). For example, the UK’s National Savings Bank and credit unions are not subject to the CRD.

- the mechanism disqualifying a national DGS from coverage by the EDIS in case of non-compliance with its legal framework; and
- the administration of the Scheme, in particular as regards the role and operational function of national deposit guarantee schemes.

2.23 No agreement has yet been reached on any of these technical elements within the Council. It is clear from the Minister's letter that Member States remain divided between those seeking parallel progress on risk reduction and the EDIS, and those who want to see more progress on risk reduction measures before mutualisation of deposit guarantee schemes is considered.

2.24 The Bulgarian Presidency has scheduled the proposal for debate at the ECOFIN Council on 22 June 2018, but, given the state of the negotiations, the Member States are not expected to endorse a general approach at that meeting. The ECON Committee of the European Parliament has not yet adopted its position on the proposal, and has not currently scheduled a vote. It therefore remains to be seen when the EDIS will be approved, if at all.

Previous Committee Reports

Fifteenth Report HC 342–xiv (2015–16), chapter 7 (16 December 2015) and Tenth Report HC 71–viii (2016–17), chapter 5 (7 September 2016).

3 Banking reform: Non-Performing Loans

Committee's assessment	Politically important
Committee's decision	Cleared from scrutiny
Document details	Communication from the Commission: First Progress Report on the Reduction of Non-Performing Loans in Europe
Legal base	—
Department	Treasury
Document Number	(39445), 5213/18 + ADD 1, COM(18) 37

Summary and Committee's conclusions

3.1 In several EU countries, national banking sectors continue to hold unsustainably high levels of "bad debt": non-performing loans (NPLs) which are unlikely to ever be repaid in full, leading to a drag on bank capital, hindering new lending, and potentially posing a risk to financial stability. In March 2018, the European Commission—at the explicit request of EU Finance Ministers—will present a package of measures to help reduce overall stocks of NPLs.

3.2 A progress report published by the Commission in January 2018 set out at high level the specific policy initiatives it intends to propose.[66] These include three legislative proposals on secondary markets for bad loans, a new prudential requirement on the capital banks set aside to cover the risk of new loans becoming distressed (provisioning), and the availability of out-of-court collateral recovery mechanisms for banks. We have set out the details of these in "Background" below.

3.3 The new Economic Secretary to the Treasury (John Glen) submitted an Explanatory Memorandum on the Commission's progress report on 1 February.[67] He stated that the proposed policies are "unlikely to affect the UK" as it has "very low levels of NPLs". However, the Government supports the EU's efforts to reduce stocks of bad loans, as long as the new policies do not trigger "additional economic or market risk" and "address specific problem areas and [...] not solely be aimed at reducing aggregate NPL levels across the EU as a whole".

3.4 **The measures to reduce the volume of non-performing loans in the EU are not targeted at the UK, given its withdrawal from the EU by March 2019 and its relatively low share of NPLs compared to many other European countries. However, we cannot yet assess the potential implications of the proposed regulatory initiatives for the UK, because it is unclear how wide their scope will be and whether they could, potentially, affect British consumers and businesses.**

66 See Commission document COM(2018) 37.
67 Explanatory Memorandum submitted by HM Treasury (1 February 2018).

3.5 **Given the UK's exit from the EU, the potential impact of the three legislative proposals will flow not only from their substance. It is also highly dependent on the timetable for adoption of final legal texts by the Council and Parliament, and the terms and length of any post-Brexit transitional arrangement. During this transition period, the Government wants to stay in the Single Market and Customs Union, which—as the other Member States have repeatedly stated—would require the continued application of EU law, including new legislation that only takes effect during the transition.**[68]

3.6 **We also have concerns about the secondary market proposal with respect to its implications for consumers—including both borrowers whose loans might be sold, and retail investors that could indirectly invest in re-sold NPLs. The transfer of Northern Rock's loan book of distressed mortgages to a private equity firm sparked concerns about the consumer protection available to borrowers whose loans were sold.**[69] **Similar issues could arise if the secondary markets proposal leads to more substantial transfers of NPLs from banks to private investors. These will be issues that require careful consideration during the legislative process.**

3.7 **In anticipation of the Commission NPL proposals, we are content to clear the January progress report from scrutiny. We will report the contents of specific policy initiatives to the House and to the Treasury Committee in due course.**

Full details of the documents

Communication from the Commission: First Progress Report on the Reduction of Non-Performing Loans in Europe: (39445), 5213/18 + ADD 1, COM(18) 37.

Background

3.8 Following the financial crisis, the EU's regulatory framework for banks has been changed substantially through a new Capital Requirements Directive and the creation of a centralised supervisory and resolution mechanism for the largest banks in the Eurozone as part of the Banking Union.

3.9 However, the EU's national Finance Ministries and the European Commission remain concerned about the high stocks of non-performing loans (NPLs) on the books of European banks. An NPL is effectively a "bad loan" where the borrower is not paying interest or making repayments as scheduled, for example on a mortgage or a business loan. The build-up of NPLs has macroeconomic consequences, as they lock in capital and make it more difficult for banks to lend, as well as posing a risk to financial stability (as shown by the sub-prime mortgage crisis).

3.10 Although stocks of non-performing loans are decreasing in the EU, and are now at their lowest level since late 2014, nine EU countries[70]—not including the UK—still have NPL ratios of more than 10 per cent in their banking sector. The overall stock of bad

68 European Council guidelines of 15 December 2017, para. 4: "In order to ensure a level playing field based on the same rules applying throughout the Single Market, changes to the acquis adopted by EU institutions, bodies, offices and agencies will have to apply both in the United Kingdom and the EU".

69 See for example the Treasury Committee's 2015 correspondence with HM Treasury on the sale of Northern Rock's loan book to Cerberus Capital Management.

70 Bulgaria, Croatia, Cyprus, Greece, Hungary, Ireland, Italy, Portugal and Slovenia. The UK, along with Luxembourg, Sweden and Finland, has one of the lowest levels of NPLs in the EU.

loans across the EU—amounting to €950 billion (£842 billion)[71]—is also still higher than it was before the financial crisis. As part of wider efforts to reduce overall risk in the banking system,[72] the EU wants to permanently reduce the volume of NPLs. Although the European Commission has stated that the primary responsibility for this lies with banks themselves, they also see a "clear EU dimension […] given the interconnectedness of the banking system of the EU and particularly of the euro area".[73]

The FSC Report on non-performing loans

3.11 In July 2016, the EU Member States established a "Subgroup on Non-Performing Loans" within the Council's Financial Services Committee (FSC)[74] to "assess the state of play regarding current NPL stocks and related developments in Member States and at EU level, as well as the relevant legal framework at national and EU level" and to deliver "possible options supporting a significant and sustainable reduction of NPL levels, based on the current diverse situations assessed".[75]

3.12 The FSC produced a final report with policy recommendations in May 2017. It proposed the EU and its Member States should take action in four policy areas:

- enhancing **supervision of banks** to ensure they are implementing the necessary measures to reduce their NPL stocks;
- ensuring that the legal frameworks for **insolvency and debt recovery** facilitate the restructuring of viable businesses in financial difficulty, strengthen "debtor discipline" to incentivise timely repayments of loans, and facilitate enforcement of claims before and after insolvency of the borrower;
- improving the EU's **secondary market for non-performing loans** that allows banks to sell their loans to investors, and with it transfer the associated financial risks; and
- **restructuring of the banking system**, for example through new ways of identifying bad loans early on or concentrating them in separate entities, to help banks absorb losses from NPLs in a sustainable way and modify their operations to prevent future build-ups of bad loans.

The Council's Action Plan on Non-Performing Loans

3.13 Based on the recommendations contained in the FSC report, EU Finance Ministers adopted an "Action Plan" in July 2017 calling for a number of EU-level initiatives—both legislative and non-legislative—to reduce the stock of "bad loans" on the books

71 €1 = £0.88723 or £1 = €1.12710 as at 29 December.
72 See for example the separate chapters in this Report on the Risk Reduction Measures package for banking reform.
73 See COM(2018) 37, p. 2.
74 The Council's Subgroup on NPLs was composed of representatives from all interested Member States, the European Commission, the European Central Bank (ECB), the European Systemic Risk Board (ESRB), the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), the European Investment Bank (EIB) and the Single Resolution Board (SRB).
75 http://data.consilium.europa.eu/doc/document/ST-9854–2017-INIT/en/pdf.

of European banks.[76] This Action Plan called upon various institutions—including the European Commission—to take appropriate measures to further address the challenges of high NPL ratios in Europe.

3.14 While stressing that banks are "primarily responsible" for restructuring their business models and resolving their NPLs issues in a timely manner, the Council said that "further measures to address the existing stock of NPLs and to prevent the future emergence and accumulation of NPLs would be beneficial for the EU as a whole by contributing to enhanced growth and reducing financial fragmentation". The Finance Ministers called on the European Commission and the European Banking Authority to take a number of concrete steps, including notably:

- the introduction of a new statutory prudential requirements for newly-originated loans to prevent banks from under-provisioning, for example by imposing compulsory prudential deductions from banks' "own funds" of NPLs;
- giving regulators greater insight into NPL volumes by introducing stricter disclosure requirements on banks as regards their asset quality and non-performing loans;
- publishing a "blueprint" with practical recommendations for the establishment of national Asset Management Companies (AMCs) by individual Member States, which would purchase NPLs from banks without breaching EU banking or state aid legislation;
- establishing an EU-level regulatory framework for the secondary market for NPLs, where investors purchase bad loans from banks.[77] This would be facilitated by a European NPL transaction platform, which would act as a central marketplace by providing transparent information about bad loans such as legal documentation relating to the loan, information on any collateral and the borrower's history of interaction with the lender;
- issuing new guidance to banks on ways of reducing their stocks of bad loans,[78] and on the governance of banks' lending practices (including for example borrower affordability assessments and monitoring of outstanding loans);
- publish the results of the benchmarking exercise on the efficiency of national loan enforcement (including insolvency) regimes from a bank creditor perspective, taking into account the European Commission's proposal for an Insolvency and Business Restructuring Directive;[79] and
- analysing the potential need for EU legislation to improve the ability of secured creditors of recovering value from a debtor's collateral in case the borrower defaults on their loan.

76 http://www.consilium.europa.eu/en/press/press-releases/2017/07/11/conclusions-non-performing-loans.

77 The ECB has described the existing secondary market for NPLs in the Eurozone as an oligopsony, where a few investors dominate the market because the very high cost of accurately valuating bad loans prevent other buyers from entering the market.

78 The European Central Bank has already issued guidance on non-performing loans for large Eurozone banks outlining possible approaches to reducing NPL stocks sustainably.

79 See the Committee's Report of 31 January 2018 for more information on the Insolvency and Business Restructuring Directive.

European Commission progress report

3.15 In January 2018, the European Commission published its first report on the progress made towards the objectives of the Council's Action Plan. It outlined the status of the Commission's preparations for a "comprehensive package" of measures to reduce the stock of non-performing loans in the EU, including three legislative proposals.[80] The package, which is due to be published in March 2018, will consist of the following measures:

- a legislative proposal for an EU-wide regulatory framework for the **secondary market for non-performing loans**, to lower the barriers to entry for investors such as loan servicers, creating competitive pressure on the demand side of the NPL market.[81] The Commission and ECB are also developing an **NPL transactions platform** where information relating to distressed loans would be made available to potential investors;[82]

- a legislative proposal to give creditors in any EU Member State recourse to out-of-court "**Accelerated Extrajudicial Collateral Enforcement**" (AECE), which would enable them to recover the value of collateral put up by businesses (but not consumers) more efficiently;

- a legislative proposal to amend the Capital Requirements Regulation, introducing a **statutory prudential backstop to prevent the risk of under-provisioning of NPLs**. Such backstops, on newly originated loans that later turn non-performing, would amount to minimum levels of provisions and deductions from own funds that banks would be required to make to cover incurred and expected losses on new lending;[83]

- a "blueprint" on how EU countries can establish **national Asset Management Companies** (AMCs), which would purchase NPLs from banks to remove them as a source of potential financial instability, in compliance with EU banking and state aid law;

- the results of a **benchmarking exercise of loan enforcement regimes** across all EU Member States aimed at assessing the delays and value-recovery banks experience when faced with borrower defaults; and

- possibly, a **common definition of non-performing exposures** (NPE) to help establish a common legal basis for the consistent prudential treatment of such exposures.[84]

3.16 In its report, the Commission also urged the Member States and the European Parliament to accelerate negotiations on the proposed Insolvency and Business

80 The "NPL package" was first announced in the Commission's policy paper on the Eurozone's Banking Union in October 2017. See for more information Commission document COM(17) 592. The document was cleared from scrutiny on 21 November 2017.

81 The Commission consulted on the development of the EU's secondary market for NPLs in summer and autumn 2017.

82 ECB, "Overcoming non-performing loan market failures with transaction platforms" (November 2017).

83 The Commission consulted on the prudential backstop for provisioning for new loans in November 2017.

84 A common definition already exists for supervisory reporting purposes under Commission Implementing Regulation (EU) No 680/2014.

Restructuring Directive, which would harmonise certain aspects of national laws governing insolvency and restructuring of businesses in financial difficulty.[85] The Committee last considered the state of play in those negotiations in January 2018.[86]

3.17 As the specifics of each of the elements of the NPL package are not yet available, it is not yet possible to assess the implications of the Commission's initiatives for the UK (in the context of its withdrawal from the EU). The Committee will consider the substance of the new policy proposals that form part of the NPL package in more detail after they are published by the Commission and deposited for scrutiny by the Government in March.

Further initiatives by other EU bodies

3.18 In addition to the major policy initiatives being taken forward by the Commission, other EU bodies are also taking steps to implement the recommendations made by the Council last year.

3.19 In the summer of 2018, the European Banking Authority will issue guidelines on banks' management of non-performing loans and on their lending practices to prevent unaffordable loans from being made. The EBA will also issue non-binding guidelines by the end of 2018 to improve banks' regulatory disclosure of information on stock of non-performing loans, as well forbearance activities[87] and foreclosures related to their loans. Separately, the European Systemic Risk Board is expected to adopt a new report on macroprudential approaches to tackling NPLs in September.

The Government's view

3.20 The Economic Secretary to the Treasury (John Glen) submitted an Explanatory Memorandum on the Commission's progress report and proposed policy initiatives on 1 February 2018. He says:

> "The UK has very low levels of NPLs and any policy measures taken to address NPLs are unlikely to affect the UK. But the issue remains politically charged within the EU, reflecting broader tensions between northern and southern Europe on questions of prudential policy and fiscal responsibility.
>
> The Government supports work on NPLs to improve financial stability and free up lending to more productive sectors of the economy. The Government agrees with the position adopted by a range of other Member States that measures taken should avoid giving rise to additional economic or market risk.
>
> Any policy solutions to the NPL problem should be targeted to address specific problem areas and should not solely be aimed at reducing aggregate NPL levels across the EU as a whole."

Previous Committee Reports

None.

85 The Insolvency and Business Restructuring Directive would harmonise aspects of insolvency laws across the EU to support business rescue and a second chance for entrepreneurs.

86 See our Report of 31 January 2018 for more information. The proposed Directive remains under scrutiny.

87 Forbearance is repayment relief granted by a lender to a borrower at the former's discretion.

Formal Minutes

Wednesday 21 February 2018

Members present:

Sir William Cash, in the Chair

Geraint Davies	Darren Jones
Steve Double	Mr David Jones
Richard Drax	Stephen Kinnock
Marcus Fysh	Andrew Lewer
Kelvin Hopkins	Michael Tomlinson

4. Banking Reform

Draft Report, *Banking Reform*, proposed by the Chair, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1.1 to 3 read and agreed to.

Summary agreed to.

Resolved, That the Report be the Fifteenth Report of the Committee to the House.

Ordered, That the Chair make the Report to the House.

[Adjourned till Thursday 22 February at 10.20 am.

Standing Order and membership

The European Scrutiny Committee is appointed under Standing Order No.143 to examine European Union documents and—

a) to report its opinion on the legal and political importance of each such document and, where it considers appropriate, to report also on the reasons for its opinion and on any matters of principle, policy or law which may be affected;

b) to make recommendations for the further consideration of any such document pursuant to Standing Order No. 119 (European Committees); and

c) to consider any issue arising upon any such document or group of documents, or related matters.

The expression "European Union document" covers—

i) any proposal under the Community Treaties for legislation by the Council or the Council acting jointly with the European Parliament;

ii) any document which is published for submission to the European Council, the Council or the European Central Bank;

iii) any proposal for a common strategy, a joint action or a common position under Title V of the Treaty on European Union which is prepared for submission to the Council or to the European Council;

iv) any proposal for a common position, framework decision, decision or a convention under Title VI of the Treaty on European Union which is prepared for submission to the Council;

v) any document (not falling within (ii), (iii) or (iv) above) which is published by one Union institution for or with a view to submission to another Union institution and which does not relate exclusively to consideration of any proposal for legislation;

vi) any other document relating to European Union matters deposited in the House by a Minister of the Crown.

The Committee's powers are set out in Standing Order No. 143.

The scrutiny reserve resolution, passed by the House, provides that Ministers should not give agreement to EU proposals which have not been cleared by the European Scrutiny Committee, or on which, when they have been recommended by the Committee for debate, the House has not yet agreed a resolution. The scrutiny reserve resolution is printed with the House's Standing Orders, which are available at www.parliament.uk.

Current membership

Sir William Cash MP (*Conservative, Stone*) (Chair)

Douglas Chapman MP (*Scottish National Party, Dunfermline and West Fife*)

Geraint Davies MP (*Labour/Cooperative, Swansea West*)

Steve Double MP (*Conservative, St Austell and Newquay*)

Richard Drax MP (*Conservative, South Dorset*)

Mr Marcus Fysh MP (*Conservative, Yeovil*)

Kate Green MP (*Labour, Stretford and Urmston*)

Kate Hoey MP (*Labour, Vauxhall*)

Kelvin Hopkins MP (*Independent, Luton North*)

Darren Jones MP (*Labour, Bristol North West*)

Mr David Jones MP (*Conservative, Clwyd West*)

Stephen Kinnock MP (*Labour, Aberavon*)

Andrew Lewer MP (*Conservative, Northampton South*)

Michael Tomlinson MP (*Conservative, Mid Dorset and North Poole*)

David Warburton MP (*Conservative, Somerton and Frome*)

Dr Philippa Whitford MP (*Scottish National Party, Central Ayrshire*)