Skadden | The Capital Ratio

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Roundup of Upcoming UK Regulatory Reforms for Financial Institutions

UK regulators have recently announced a number of reforms for banks and other financial institutions.

- On 23 November 2023, the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) (together, the "regulators") issued consultation papers on proposed updates to the UK change-in-control regime.
- On 5 December 2023, the PRA released a policy statement on a "Strong and Simple Framework" for UK banks.
- The regulators also released a joint policy statement on the proportionality of remuneration requirements for small firms.
- In addition, the PRA released a consultation paper outlining proposals on the management of step-in and other risks.

In this alert, we consider the key features and impacts of these upcoming regulatory reforms and proposals. We will separately consider in our next issue of *The Capital Ratio* reforms relating to the implementation of the Basel 3.1 standards, including the recent Bank of England policy statement released on 12 December 2023.

Change-in-Control Approval: Proposed Modifications

Key Points

- The existing European Union guidelines addressing change-in-control approvals, which were retained post-Brexit, will be replaced by UK-specific rules and regulatory guidance. There are significant additions and clarifications that will impact the approach to change-in-control notifications going forward.
- The changes are tailored to the UK market and the UK's regulatory approach post-Brexit. New information requirements have been proposed in relation to private equity (PE) funds, hedge funds, sovereign wealth funds, investment firms and cryptoasset businesses.
- There is revised guidance on the "significant influence" threshold of acquiring control and when a "decision to acquire" control has been made that would trigger a regulatory approval requirement (which will also be of interest to acquisitions of control by PE and other fund structures).

The proposed changes to the UK's change-in-control regime would replace the existing EU guidance (the EU Guidelines) that currently inform the UK's regulatory approach to change-in-control applications.

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The new regime will be implemented through a new PRA supervisory statement and new FCA guidance, drafts of which were appended to the consultation paper. To a large extent, these proposals reflect the EU Guidelines. Most changes involve simplifications, updates and tailoring to align with the UK's post-Brexit regulatory approach. There are, however, some material proposals for specific categories of regulated firms, as well as useful clarifications of certain concepts.

Controller Concepts

- **Decision to acquire:** The regulators have clarified the established guidance to determine when a person has decided to acquire, increase or dispose of control in a regulated target firm, which is the time at which an obligation to notify the regulators arises. Whether a proposed acquirer was aware (or should have been aware) of the acquisition/increase in control or the transaction giving rise to it, and whether the acquirer had the ability to influence, object to or prevent the proposed acquisition/increase in control, are the factors relevant to the "decision to acquire."
- **Impact on LPs:** This revised guidance could encompass limited partners (LPs) in fund structures as controllers. LPs might otherwise have been able to argue that the general partner/manager of the fund makes any decision to acquire and not the LPs, in order to obviate the need for the LPs to obtain pre-approval.
- **Expectation of a "decision-to-acquire" finding:** Importantly, the regulators expect "there to be a finding of a decision to acquire [control] in almost all circumstances, as almost always the acquirer will have taken or omitted to take certain action which will have contributed to the circumstances leading to an acquisition or a control threshold being crossed." The sole illustration given of an instance where there was no "decision to acquire" is the involuntary crossing of a threshold as a result of a repurchase of shares by another person that serves to reduce the overall share count, thereby increasing the percentage shareholding of the remaining shareholders. This is a very narrow illustration, which may indicate a hardening of the approach to acquisitions by fund structures and the treatment of LPs.
- **Significant influence:** The concept of "significant influence" is developed through a list of UK-specific examples the regulators have encountered regarding, for instance, board seat rights, regular transactional interactions, and contractual or other veto rights relating to the regulated target firm, potentially amounting to control based on "significant influence." Close analysis of governance and other rights would likely have to be carried out, and early engagement with the regulator to determine whether there is "significant influence" may be needed. This has the potential to introduce a level of discretion and uncertainty in controller assessments.

Additional Information Requirements

- **Private equity, hedge funds and sovereign wealth funds:** Ownership at 20% or more of a regulated firm by a PE or hedge fund will likely trigger a requirement to provide regulators with various additional information, namely:
  - A detailed description of the performance of previous acquisitions in financial institutions.
  - Details relating to the investment policy and any restrictions on investment, including investment monitoring, investment rationale and the exit strategy.
  - The framework for investment decisions, including the details of the decision-making individuals.
  - The anti-money laundering procedures and framework of the proposed controller.

Sovereign wealth fund owners would be required to detail the government department defining the fund's investment policy and the department's influence on the day-to-day operations of the fund as well as on the regulated target firm, details of the investment policy and restrictions on investment, and details of the decision-making individuals. This represents a significantly more comprehensive burden in relation to fund ownership than the current general practice of UK regulators.

- **Investment managers:** For investment firms, the FCA may require additional financial information where the acquisition might result in (or add to) a consolidated UK investment group, such as group forecasts or management accounts, and proof of an ability to satisfy the capital and liquidity standards applicable to such firms.
- **Cryptoasset businesses:** The FCA will likely engage relevant stakeholders to assist with their controller assessment, which may lead to additional information being required for the assessment.
- **Holding companies:** If the transaction results in an acquirer becoming a parent financial holding company or parent mixed financial holding company in the UK (of a consolidated group containing a UK bank or certain large investment firms), the company must complete an application for a PRA approval or exemption.
- **Multiple authorised firms:** The regulators expect that a transaction leading to control of more than one regulated entity will require additional information on potential conflicts of interest.

Lighter Level of Assessment in Certain Circumstances

The FCA has indicated that it would vary the intensity of its assessment and information requirements in accordance with the

nature, scale and complexity of the proposed transaction. Further factors that may influence the level of assessment include a controller's regulatory history in the UK and whether the controller, or its group, are subject to equivalent third-country supervision.

Illustrative examples of where this lighter-touch approach may be taken include:

- **Intragroup transactions:** In these scenarios, the regulatory assessment may be focussed on the transaction's effect on the internal group structure. The controller forms in these transactions contain reduced information requirements.
- **Investment firms below 20%:** Controllers in this scenario can benefit from the investment manager form, which involves providing a declaration instead of information requirements.
- **A proposed controller already known to the FCA and in possession of up-to-date information:** In such cases, the FCA may be satisfied with assessing only the corporate entity at the top of the control chain.
- **A change in the nature of a controller:** An example of this scenario would be a controller moving up a control band, in which case the assessment may be limited to changes that have occurred since the most recent assessment, or to proposed changes affecting the regulated firm.

Further Changes

- The proposals contain references and guidance relating to the regulators' use of the conditional approval powers granted to them recently under legislation, which might be exercised where the imposition of conditions is desirable to advance the regulators' objectives. This is likely to be used when there are outstanding issues relating to a target firm where conditions might be imposed to address such issues. There may be an increased use of conditional approvals, although how the power is used in practice remains to be seen.
- In assessing the propriety of a proposed individual controller, the FCA would assess any record of insolvencies of companies where the individual was a director or was otherwise involved within one year prior to its dissolution, and where that dissolution gave rise to significant customer liabilities.
- The regulators will assess the capabilities of senior personnel the controller may appoint to the regulated target firm using the Senior Managers and Certification Regime (SMCR). Senior Management Function applications should be submitted as close to simultaneously as the change-in-control notification as possible, and possibly before it in draft form. Individuals appointed to non-executive director roles will also be subject to a similar suitability assessment on reputation, knowledge, skills and experience in directing the business of the target firm.

These proposals contain some significant and effectively new requirements for certain fund acquirors, but equally some welcome, pragmatic relaxations of the assessment process. The consultation closes on 24 February 2024, with the final regime due to be implemented in summer 2024.

The Strong and Simple Framework

The PRA's policy statement details its final approach to a system of simplified rules for eligible banks and building societies, known as the Strong and Simple Framework. Firms that meet certain eligibility criteria are known as Small Domestic Deposit Takers (SDDTs).

SDDTs will be able to benefit from relaxations to the current rules, including:

- The introduction of a new Retail Deposit Ratio (RDR) that, if in excess of 50% over four consecutive quarters, will relieve firms from the need to comply with the Net Stable Funding Ratio (NSFR).
- The general removal of Pillar 2 liquidity add-ons and the introduction of a streamlined template for the Individual Liquidity Adequacy Assessment Process (ILAAP).
- Relieving SDDTs from the requirement to file certain Additional Liquidity Monitoring Metric (ALMMs) returns. These returns capture liquidity and funding profile risks that are not otherwise addressed in NSFR and Liquidity Coverage Ratio (LCR) metrics.
- Requiring those SDDTs that have listed instruments to be subject to new Pillar 3 disclosures, and exempting those that do not have listed instruments.

We discuss below the scope of the SDDT regime and the particular dispensations from the current regulatory framework.

SDDT Criteria

The Strong and Simple Framework benefits SDDTs that are Capital Requirement Regulation (CRR) firms — specifically, UK banks or building societies — or CRR consolidation groups that satisfy the SDDT criteria.

The criteria comprise the following:

- **Asset size:** Total asset value of below £20 billion. This is to be calculated using the mean value of a firm's total assets that it was required to report over the preceding 36 months.
- **Domestic activity:** The ratio of a firm's relevant UK credit exposures to its relevant credit exposures across all jurisdictions to average at least 85% in the preceding 36 months, and not to fall below 75%. Exposures to UK property, irrespective of the jurisdiction of a borrower/obligor, counts as a UK exposure.

- **Trading activity:**
  - The size of a firm's on- and off-balance sheet trading book business cannot exceed 5% of the firm's total assets, nor can it exceed £44 million.
  - A firm cannot hold positions in commodities or commodity derivatives.
  - A firm's net foreign exchange position is limited to 2% of its own funds on average (which it can exceed for no more than three months in succession and no more than six months in the preceding year, and cannot exceed 3.5% during such periods).
- **Standardised approach to credit risk:** Firms must be using the standardised approach to calculating credit risk capital charges.
- **Exclusion of certain services:** A firm cannot provide clearing, settlement and custody services, or operate a payment system to a UK bank, building society or non-UK credit institution. This includes acting in an intermediary role. There is, however, an exception where the services in British pound sterling are provided to another UK-based member of the firm's group.
- **Any parent undertaking of the firm must be a UK entity:** This requirement is subject to possible allowances, as further discussed below.

These criteria largely align with those that apply to "small CRR firms," considered later in this alert, though requirements for the two regimes diverge in certain aspects.

Level of Application

The PRA has confirmed that firms will need to apply the criteria on a solo basis, while firms within a consolidation group must apply the eligibility assessment at the highest level of the UK consolidation group. SDDT qualification for consolidation groups will be achieved where both the UK consolidating entity and each firm within the consolidation group meet the criteria.

The SDDT regime operates on an opt-in model, allowing firms to access the regime where they meet the criteria and apply to the PRA for designation as an SDDT. In certain circumstances, firms that do not meet all SDDT criteria but have a strong argument for inclusion within the SDDT regime can apply to the PRA to be treated as an SDDT.

UK subsidiaries of foreign holding companies or banking groups can apply for such a waiver on a solo basis, which the PRA will consider in the context of the wider group's compatibility with the SDDT regime. The PRA has indicated that a firm that is a member of a foreign group will likely be successful in applying for the SDDT regime where the group's total assets are assessed at under £20 billion and where it satisfies each of the remaining SDDT criteria.

The consolidating entity will be responsible for all relevant firms within the group. This ensures that an approved holding company consents to the designation as an SDDT consolidation group.

Changes

Net Stable Funding Ratio: The PRA has confirmed the introduction of the RDR to replace the NSFR for SDDT firms. Such a firm is required to have at least 50% of its funding (excluding its own funds) in the form of retail deposits, which comprise those made by individuals as well as small and medium-sized enterprises (SMEs) — but only up to £880,000. Where this ratio exceeds 50% over four consecutive quarters, firms are not required to apply the NSFR.

Pillar 2 liquidity: SDDTs will not face Pillar 2 liquidity add-ons, unless "idiosyncratic" risks demand otherwise. Further, firms will benefit from a streamlined ILAAP, though this is still required to be produced yearly.

Liquidity reporting: SDDT firms will be exempt from reporting on four of the five ALMMs: the concentration of funding by a counterparty, prices for various funding lengths, funding roll-over and the concentration of counterbalancing capacity. Reporting on concentration by product type is simplified to include all product types.

Pillar 3 disclosures: The PRA confirmed its bifurcated approach to Pillar 3 disclosure requirements, where unlisted SDDT firms will not be obliged to make any Pillar 3 disclosures. Listed SDDT firms will be required to make Pillar 3 disclosures relating to their risk-weighted exposures and key metrics such as their leverage and capital ratios.

Remuneration disclosures: Unlisted SDDT firms are exempt from any Pillar 3 remuneration disclosure requirements. These requirements for listed SDDT firms cover information on: decision-making processes for remuneration determinations, the link between pay and performance, the design of the remuneration system and the fixed-to-variable remuneration ratio. Listed firms must also make remuneration disclosures by applying the UK REM1 template. The remuneration disclosure requirements for SDDTs will also apply for institutions that are small CRR firms (a designation discussed further in this alert) but that may not be eligible for the SDDT regime.

Implementation

The rules relating to the definition of an SDDT and its eligibility criteria, along with changes to the PRA Rulebook, become effective from 1 January 2024. The new disclosure rules will apply from 1 July 2024.

Roundup of Upcoming UK Regulatory Reforms for Financial Institutions

Changes to Remuneration Requirements

The regulators' joint policy statement outlines enhanced proportionality of remuneration requirements to smaller firms. This follows consultation papers published in May 2023 and will impact firms, including banks, building societies and PRA-designated investment firms.[1]

The changes to remuneration requirements are intended to align the approaches of the PRA and FCA for dual-regulated firms. Under the reissued proportionality regimes, the criteria for qualifying as a "small firm" is being amended such that the rules on *ex post* risk adjustments for such firms (*i.e.*, no downward adjustment to deferred bonus amounts (malus) and no clawback requirements for bonuses already paid (clawback)) will not apply to them.

The changes came into force on 8 December 2023 and are effected by amendments to the PRA Rulebook and the FCA Handbook, changes to a PRA supervisory statement and amendments to non-Handbook FCA guidance. They will be relevant for performance years beginning on or after 8 December 2023.

Small Firm Criteria

The definition of a "small CRR firm" or "small third-country CRR firm" (*i.e.*, a UK branch of a non-UK bank, and jointly, "small firms") are now aligned with the thresholds and criteria found in the SDDT regime. There are, however, certain differences in the conditions that apply under each regime.

The criteria for a "small firm" are as follows:

- total assets of £4 billion or less; or
- total assets of £20 billion or less subject to the firm satisfying the following criteria:
  - the size of the firm's on- and off- balance-sheet trading book business does not exceed £44 million, nor does it exceed 5% of the firm's total assets, as assessed on the final day of at least one of the last three months and on the last day of at least six of the last 12 months;
  - the firm's net foreign-exchange position was less than or equal to 3.5% of its regulatory capital and did not exceed 2% of its regulatory capital on average. This must be the case as of both one or more of the preceding three months and six or more of the preceding 12 months;
  - the firm does not hold commodity or commodity derivative positions;
  - the firm cannot provide clearing, settlement and custody services, or operate a payment system to a UK bank, building society or non-UK credit institution (This includes acting in an intermediary role. There is, however, an exception where the services are provided to another UK-based member of the firm's immediate group.); and
  - the firm cannot be an operator of a payment system.

These same criteria apply to small third-country CRR firms.

The FCA's changes to the proportionality thresholds for remuneration requirements mirror the PRA's stance. In particular, the FCA terms "code staff, " "material business units" and "material risk takers" are now defined by reference to the PRA Rulebook, as amended from time to time.

Small Firm Rules

The changes remove the application of malus and clawback provisions to small firms. Rules relating to buyouts (where a firm compensates new hires for the sum of deferred variable remuneration lost or reduced in the course of exiting their previous position) are also disapplied. The PRA has instead introduced a requirement for small firms to "proactively disclose any material changes in their remuneration structures."

In relation to disclosures, the PRA has laid out its revised rules on proportionate remuneration disclosure requirements in the separate policy statement (PS 15/23) as part of the Strong and Simple Framework, discussed above.

Groups

The new rules make it clear that the simplified regime only applies where all firms in a group meet the thresholds at both the individual and consolidated group levels.

Where CRR firms or third-country CRR firms in the group are part of a consolidation group, the consolidation group cannot have average total assets exceeding £4 billion on a consolidated basis, or £20 billion on a consolidated basis so long as the first three of the additional SDDT criteria are met (*i.e.*, those relating to trading book business size, net foreign-exchange position and restrictions on commodity holdings).

If a multinational banking group has a UK branch or subsidiary that is not part of a UK consolidation group, the following criteria must be satisfied:

- The average total assets of each CRR firm in the group do not exceed £4 billion on an individual basis, nor do the average total assets for the activities of the individual UK branch operation of each third-country CRR firm in the group exceed £4 billion.

[1] CP5/23 – Remuneration: Enhancing Proportionality for Small Firms and CP23/11 – Remuneration: Enhancing Proportionality for Dual-Regulated Firms.

- Alternatively, the average total assets of each CRR firm, and each third-country CRR firm, in the group do not exceed £20 billion on an individual basis, so long as the additional criteria outlined above for SDDTs are satisfied.

Step-In Risk, Shadow Banking Entities and Groups of Connected Clients

The PRA has published proposals on the assessment of step-in risk in relation to non-SDDT CRR firms. Step-in risk arises where a bank directs its resources to support an unconsolidated distressed entity absent any contractual obligation to do so.

The PRA's proposals have been informed by the Basel Committee on Banking Supervision's guidelines on this topic and require CRR firms (at a consolidated level for most firms) to assess their step-in risks according to established policies and procedures. The results of this assessment would be reported to the PRA.

The consultation paper also proposes the publication of a supervisory statement to reflect the European Banking Authority's (EBA's) guidelines on limiting exposure to shadow banks (entities that offer unregulated "bank-like" services), subject to some amendments. The PRA plans to do the same for guidelines relating to large exposures (exposures to "a large counterparty or a group of connected clients").

The consultation closes on 5 March 2024, and the changes have a proposed effective date of 1 January 2026. The frameworks are intended to integrate existing EBA guidelines into a clear UK prudential policy landscape.