HOUSE OF LORDS

European Union Committee

11th Report of Session 2017–19

Brexit: the future of financial regulation and supervision

Ordered to be printed 23 January 2018 and published 27 January 2018

Published by the Authority of the House of Lords

HL Paper 66

The European Union Committee

The European Union Committee is appointed each session "to scrutinise documents deposited in the House by a Minister, and other matters relating to the European Union".

In practice this means that the Select Committee, along with its Sub-Committees, scrutinises the UK Government's policies and actions in respect of the EU; considers and seeks to influence the development of policies and draft laws proposed by the EU institutions; and more generally represents the House of Lords in its dealings with the EU institutions and other Member States.

The six Sub-Committees are as follows:

Energy and Environment Sub-Committee
External Affairs Sub-Committee
Financial Affairs Sub-Committee
Home Affairs Sub-Committee
Internal Market Sub-Committee
Justice Sub-Committee

Membership

The Members of the European Union Select Committee are:

Baroness Armstrong of Hill Top
Lord Boswell of Aynho (Chairman)
Baroness Brown of Cambridge
Baroness Browning
Lord Crisp
Lord Cromwell
Baroness Falkner of Margravine
Lord Jay of Ewelme
Baroness Kennedy of The Shaws
The Earl of Kinnoull
Lord Liddle
Baroness Neville-Rolfe
Lord Selkirk of Douglas
Baroness Suttie
Lord Teverson
Baroness Verma
Lord Whitty
Baroness Wilcox
Lord Woolmer of Leeds

The Members of the Financial Affairs Sub-Committee, which conducted this inquiry, are:

Lord Bruce of Bennachie
Lord Butler of Brockwell
Lord De Mauley
Lord Desai
Baroness Falkner of Margravine (Chairman)
Lord Fraser of Corriegarth
Lord Haskins
Baroness Liddell of Coatdyke
The Earl of Lindsay
Baroness Neville-Rolfe
Lord Skidelsky
Lord Woolmer of Leeds

Further information

Publications, press notices, details of membership, forthcoming meetings and other information is available at http://www.parliament.uk/hleu.

General information about the House of Lords and its Committees is available at http://www.parliament.uk/business/lords.

Sub-Committee staff

The staff of the Sub-Committee during this inquiry were Matthew Manning (Clerk), Holly Snaith (Policy Analyst) and Claire Coast-Smith (Committee Assistant).

Contact details

Contact details for individual Sub-Committees are given on the website. General correspondence should be addressed to the Clerk of the European Union Committee, Committee Office, House of Lords, London, SW1A 0PW. Telephone 020 7219 5791. Email euclords@parliament.uk.

Twitter

You can follow the Committee on Twitter: @LordsEUCom.

CONTENTS

Evidence is published online at https://www.parliament.uk/financial-regulation-supervision-inquiry-lords and available for inspection at the Parliamentary Archives (020 7219 3074).

Q in footnotes refers to a question in oral evidence

SUMMARY

Open and globalised capital markets are in the interests of both the UK and the EU. Operating against the backdrop of a robust regulatory framework, they promote financial stability and give businesses and consumers access to the products and services they need. The Government has stated that the UK will leave the EU Single Market, which allows for the free flow of financial services across the borders of 28 Member States, when it exits the EU. It is imperative that doing so does not undermine the benefits of participation in a globalised financial system.

In agreeing the relationship between the UK and the EU post-Brexit, both sides should favour an end state allowing mutual market access. Fragmentation would lead to costs increasing and to financial stability deteriorating. The dangers of disintegration are already apparent in proposals that envisage the possibility of relocating the clearing activity of central counterparties (CCPs) to the EU, and in the political rather than purely economic calculations emerging in the broader Brexit negotiations.

In defining the future environment for financial services, regulation and supervision are key. Brexit will not automatically entail divergence from the EU's standards, and there are sound reasons for the UK to maintain a high degree of regulatory alignment with the EU in financial services as part of preserving mutual market access.

An agreement based merely on the EU's present 'equivalence' framework would not be a reliable long-term basis for either the UK or the EU. Any form of alignment that renders the UK a *de facto* rule taker would not be acceptable, given that future EU regulation may not be appropriate to the needs of the UK economy. The Government has said it will seek a close economic partnership with the EU, based on a free trade agreement (FTA). We agree that such an arrangement would be beneficial for both the UK and the EU.

An agreement on mutual access would need to be underpinned by broad and deep supervisory cooperation between the UK and EU. The foundations for this already exist, based in part on the renowned technical expertise of UK regulators. We conclude that both sides should maintain this cooperation, given its importance for the safety and soundness of the fabric of cross-border financial institutions that has developed as a result of the evolution of the Single Market.

The UK financial services industry is also a major part of the UK's own economy. In light of this, the Government urgently needs to offer clarity on both the future relationship it will seek to achieve in the second phase of negotiations with the EU, and on transitional arrangements. We received evidence that, without this clarity, firms may be forced to implement costly and potentially irreversible contingency plans. The Government also needs to ensure, both immediately post-Brexit and over the longer term, that the financial services industry continues to have access to the global talent on which it depends, including reviewing its visa policies.

The immediate issue the Government faces in moving towards the future relationship will be transposing the EU's body of law, the *acquis communautaire*. As the UK takes over regulation hitherto defined in EU law, substantial powers

will devolve upon the domestic regulators: the Bank of England, Prudential Regulation Authority and Financial Conduct Authority. This will require Government and Parliament to give thought to their role in overseeing the exercise of these powers, including consideration of the extra resources that may be required.

Once the UK has the capacity to exercise greater control over its domestic legislation, it will be able to tailor the regulatory framework to its own priorities in order to foster innovation, for example in the UK's burgeoning FinTech industry. There are also aspects of the EU regime that are less appropriate for the domestic UK market and that in some respects diverge from international standards. We conclude that opportunities for varying the regulatory framework where appropriate should be welcomed.

However, putting in place a suitable domestic regime cannot mean abandoning the international standards that have been crucial to repairing the global financial system since the post-2008 crisis. The UK has been instrumental in shaping and promoting those standards and has consistently advocated their faithful implementation. The UK must continue to invest in and promote global standards if it wishes to see them maintained.

Furthermore, international standards could provide a bridge between the UK and the EU in defining a future relationship based on shared outcomes, rather than the literal interpretation of rulebooks. We believe that a future relationship can be secured that is to the benefit of both the UK and EU, provided that a mutual commitment to effective regulation and supervision is maintained.

Brexit: the future of financial regulation and supervision

CHAPTER 1: INTRODUCTION

The future of financial regulation and supervision post-Brexit

1. The UK is currently subject to over 40 EU Regulations and Directives on financial services, together with innumerable pieces of technical ('level 2') legislation shaped by the European Supervisory Authorities (ESAs). The UK has also played a leading role in drafting this legislation. After it leaves the EU, the UK will have to choose how to regulate, and supervise, the domestic financial services industry. Nonetheless, the depth of the interdependence between the UK and EU means that there is likely to be mutual interest in some form of ongoing cooperation, in order to maintain access, align regulation, and ensure financial stability. This may in turn restrict the scope for regulatory innovation.

2. The UK's financial services sector is a crucial part of the domestic economy. In the words of a recent paper by the House of Commons Library:

> "In 2016, financial and insurance services contributed £124.2 billion in gross value added (GVA) to the UK economy, 7.2% of the UK's total GVA. London accounted for 51% of the total financial and insurance sector GVA in the UK in 2015. There are over one million jobs in the financial and insurance sector (3.1% of all UK jobs). The UK had a surplus of over £60 billion on trade in the financial and insurance sectors in 2016. In [2015/16], the banking sector alone contributed £24.4 billion to UK tax receipts in corporation tax, income tax, national insurance and through the bank levy."[1]

According to a report produced annually by the City of London Corporation, the UK financial sector as a whole contributed £71.4 billion in tax (which includes wider measures of taxation such as business rates), 11.5% of total government receipts, in 2015/16.[2] For 2016/17 the figures were £72.1 billion and 11% respectively.[3]

3. Moreover, serving as a hub for the provision of financial services to counterparties from third countries, including EU Member States, makes the UK financial services industry a global asset. Analysis by the consultancy Oliver Wyman calculated that annual financial revenues from the UK industry were around £200 billion, £90–95 billion of which is domestic business, £40–50 billion relates to the EU, and £55–65 billion relates to the

1 House of Commons Library, *Financial services: contribution to the UK economy*, Briefing Paper, No. 6193, March 2017

2 City of London Corporation, *Total Tax contribution of UK financial services* (9th edition), City of London Corporation Research Report (December 2016): https://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Documents/research%202016/total-tax-report-2016.pdf [accessed 12 January 2018]

3 City of London Corporation, *Total Tax contribution of UK financial services* (10th edition), City of London Corporation Research Report (November 2017): https://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Documents/research-2017/total-tax-report-2017.pdf [accessed 12 January 2018]

rest of the world.[4] London is, as Professor Eilís Ferran, Professor of Company and Securities Law at the University of Cambridge, noted, "the home location for systemically important banks globally".[5] The concentration of service provision within London is such that it could not be straightforwardly replicated by another European hub, and if fragmentation occurs, it would carry significant costs for consumers across both the UK and EU. Simon Gleeson, Partner at Clifford Chance, summarised the "really significant concern in the industry" that the upshot of the Brexit process will be "to make European financial service provision … uncompetitive globally".[6]

4. The UK's regulatory and supervisory system is a key element of the UK's pre-eminence as a financial services centre. Stephen Barclay MP, the City Minister,[7] told us that "the United Kingdom's regulatory strength is seen as one of the industry's key strengths, alongside our legal system, time zone, expertise and talent".[8] A well-designed regulatory structure will continue to be important to preserving London's financial services 'ecosystem'—the suite of services that the UK is able to offer—which means that the future should not include a race to the bottom on regulation. Mark Hoban, a former City Minister and Chair of the International Regulatory Strategy Group (IRSG), concurred: "It is very clear from talking to members of the IRSG and to City businesses that they are not looking for a bonfire of regulations post-Brexit. They believe that strong regulation is an asset for London post Brexit and would expect the regulators to continue in that vein."[9]

5. UK financial services institutions that sell products into the EU Single Market can currently do so via the pan-EU 'passport', which allows a firm authorised in one EU ('home') Member State, to provide services or open branches in other EU ('host') Member States, with relatively few authorisation requirements.[10] Passporting is based on principles established by the common prudential capital regime established under EU law, and on the mutual recognition of licences. Banks, insurers and other financial services firms based in the EU engage in the same process in order to access the UK's market. Financial services across the UK and EU-27 have therefore grown symbiotically since passporting was established in the 1980s, and it will prove very difficult to separate the two. As Sam Woods, the Bank of England's Deputy Governor for Prudential Regulation, told us, "It is pretty likely that if passporting falls away for significant sections of cross-border business … we will end up with more complicated structures of firms, because of the interconnections that there will be between business they are doing in the EU 27 and business they are doing here in London."[11]

6. Once passporting falls away, the UK and EU face substantial losses of business opportunities, unless a replacement agreement, including financial services,

4 European Union Committee, *Brexit: financial services* (9th Report, Session 2016–17, HL Paper 81) para 4
5 Q 1
6 Q 11
7 Stephen Barclay gave evidence to us on 5 December 2017, and was replaced as City Minister on 9 January 2018 by John Glen. Mr Barclay is referred to as the City Minister in the present tense throughout this report.
8 Q 117
9 Q 20
10 British Banking Association (BBA), *What is 'passporting' and why does it matter?:* Brexit Quick Brief #3: https://www.bba.org.uk/wp-content/uploads/2016/12/webversion-BQB-3-1.pdf [accessed 12 January 2018]
11 Q 67

is concluded. It is therefore critical that the financial services industry, and regulators across Europe, are given as much clarity as possible over the future relationship—and time to adapt. A transition period—discussed also in the European Union Committee's recent report, *Brexit: deal or no deal*[12]—will be crucial to achieving this aim. Some firms are already at an initial stage of implementing contingency plans, in the event that such a period is not agreed. (The evidence we received on the impact of Brexit on different sectors of the financial services industry is summarised in Appendix 5.) While analysis in 2016 by Oliver Wyman suggested 75,000 jobs being lost as a result of Brexit, Sam Woods told us that current expectations were of a "day-one movement of perhaps 10,000".[13] The future of the UK's financial services industry, and its ability to provide services to EU counterparties, will depend on the nature of a future agreement, and the period of transition to get there.

7. Dr Kay Swinburne MEP suggested that there was concern that the Government's negotiating position for financial services lacked detail. She told us that "my colleagues in Brussels have not had a clear statement about what we are looking to transition to at the end of the negotiations".[14] Karel Lannoo, Chief Executive of the Centre for European Policy Studies, thought that these concerns had also fallen by the wayside in popular consideration: he felt that that the City of London's success was a result of "the fact that it has become a capital for financial services and services more broadly in the EU", and that, regrettably, "A lot of the debates on the importance of single-market freedoms started only after the Brexit decision, not before."[15] The need for an agreed vision of what will replace Single Market membership is now urgent.

The purpose of the inquiry

8. The purpose of this inquiry was to examine how financial regulation and supervision could evolve following Brexit in order to promote the stability and development of the UK's domestic market while enabling it to continue to serve international business. The UK is a hub for a range of cross-border financial institutions, which are supervised in accordance with regulatory standards that are often set at the global level. A domestic regime for financial services will be circumscribed by the UK's continued participation in international standard-setting—and by the desire to maintain a close relationship between the UK and EU regulatory regimes in order to preserve cross-border market access. There may however be opportunities to tailor the UK's regime both to reflect our existing markets better, and to reflect those that are developing, for example in areas such as FinTech.

9. This report is usefully read alongside our previous report into financial services, *Brexit: financial services*,[16] published in December 2016, which considered the anticipated effects of withdrawal on the UK industry. Prior to this, the Committee has examined the regulatory landscape for financial services on numerous occasions, most recently in *The post-crisis EU financial*

12 European Union Committee, *Brexit: deal or no deal* (7th Report, Session 2017–19, HL Paper 46)
13 Q 64
14 Q 136
15 Q 125
16 European Union Committee, *Brexit: financial services* (9th Report, Session 2016–17, HL Paper 81)

regulatory framework: do the pieces fit?[17] in 2015. Where little substantive change has occurred, these reports are referred to directly in order to avoid repetition. The present inquiry has focused on the regulatory and supervisory implications of withdrawal, although an appendix (Appendix 5) provides a brief summary of some of the evidence we received on the differentiated impact of Brexit upon the UK financial services industry, in light of political developments since the last report.

The EU Committee's work

10. The EU Financial Affairs Sub-Committee, whose members are listed in Appendix 1, launched the inquiry at the end of July 2017 with a call for evidence. We received over 40 pieces of written evidence, and held oral evidence sessions with 13 panels of witnesses from September to December 2017. We are grateful to all our witnesses, and also to those who participated in a seminar held in collaboration with the City of London Corporation on 13 September 2017, in order to ground our thinking.

11. We tried throughout the inquiry to take evidence from a balanced range of witnesses across both the UK and EU. Indeed, we planned to take evidence from EU-based witnesses *in situ* in Brussels, as we have done during previous inquiries. However, following the EU's decision to designate Michel Barnier as its sole negotiator with the UK during the Brexit negotiations, we have been unable to secure evidence from the EU institutions; we therefore had to confine ourselves to taking evidence in London, inviting Brussels-based witnesses wherever possible. Every effort has been made to corroborate and counterbalance the evidence we received from UK-based interlocutors with statements from EU actors.

12. **We make this report to the House for debate.**

17 European Union Committee, *The post-crisis EU financial regulatory framework: do the pieces fit?* (5th Report, Session 2014–15, HL Paper 103)

CHAPTER 2: THE ORIGINS OF REGULATION AND SUPERVISION

A multi-level regulatory system

13. The body of regulation affecting UK financial services derives from many sources. A cascade of regulation flows down from the overarching standards agreed in international bodies (such as the Financial Stability Board, or FSB), of which the UK is a part; from the EU, in which the UK contributes to shaping the laws that apply to EU Member States; from Parliament, by means of primary and secondary domestic legislation; and from the UK's regulators, the Bank of England, Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA). The UK, as a member of the EU, is obliged to translate EU Directives (such as the Markets in Financial Instruments Directive, MiFID) into domestic law, and is also bound by EU Regulations (such as the Capital Requirements Regulation, the CRR), which are 'directly applicable'.

14. Within the framework of EU law, the UK has some capacity to act independently. It can, to a limited extent, interpret Directives. It can also incorporate international standards directly where these do not contradict EU law. Finally, it can legislate in areas not covered by EU law (as has been the case with measures such as the Senior Managers Regime, which is an entirely domestic initiative).

15. In the words of Andrew Bailey, Chief Executive of the FCA: "In the world in which the FCA operates at the moment, there is a split between policy originated from the EU and policy originated domestically, which in itself falls into two categories; there are things that come out of domestic legislation in the UK and things that we do ourselves."[18] Lloyd's made a broader point about the role of EU legislation in shaping the UK's room for manoeuvre, when they stated:

> "UK financial services legislation, the PRA Rulebook and the FCA Handbook are all heavily reliant on EU legislation. The regulatory rulebooks, in particular, contain 1,000s of references to EU Directives and other EU legislative provisions, to the extent that substantial portions can only be understood in the context of the EU legislation that they are implementing."[19]

16. The Government's aim is that, as a result of processes specified by the European Union (Withdrawal) Bill (see Chapter 3), the UK's regulatory regime on day one of withdrawal is likely to look much the same as it does now (albeit with amendments to the supervisory framework, given that the UK will no longer be subject to the authority of EU institutions and agencies). But while the UK's regime will from this point be within domestic control, the future scope for change will be limited both by the UK's continued subscription to international standards, and by the precise form of any agreement reached with the EU (see Chapter 5). Sir Jon Cunliffe, the Bank of England's Deputy Governor for Financial Stability, argued: "We must ensure that we maintain international standards that are implemented well in all countries. It is very important to the UK, particularly given our

18 Q 99
19 Written evidence from Lloyd's and the Lloyd's Market Association (FRS0028)

openness."[20] Andrew Bailey agreed, believing that in future it would be critical "that we do not become isolationist".[21]

International standards

17. Professor Eilís Ferran noted that the common feature of international standards was that "they are non-binding. That enables them to be high level because they are not designed to be legally enforced."[22] The Personal Investment Management and Financial Advice Association (PIMFA) also affirmed that "the implementation of global rules is mostly subject to moral suasion".[23] As a result, the effect of international standards, once incorporated into national law, has not always reflected the intentions of their originators. The City Minister, Stephen Barclay MP, gave an example: "If you look at the original intention of Basel, it was for large systemic banks, and the regulation has been applied more widely than was originally intended."[24]

18. International standards are more comprehensive in some areas than others (a list of the primary standards-setters is contained in Box 1). Professor Niamh Moloney, Professor of Financial Markets Law at the London School of Economics and Political Science, stated that international standard-setting tended to be concerned with "stability, risk management and prudential matters. It is increasingly beginning to look at conduct and investor and client-related issues, but, more often than not, issues relating to investor protection, consumer protection and conduct tend to be located in the EU or the UK".[25] TheCityUK, an industry advocacy group, also commented that "international standards on banking and prudential requirements are more developed than in other areas".[26]

19. In particular, there are gaps in the regime for insurance, which led the Association of British Insurers (ABI) to comment that "unlike the Basel framework in banking, there are no global standards for insurance regulation".[27] Clifford Chance[28] and Lloyd's[29] made the same point.

Box 1: International standards setters

The Basel Committee on Banking Standards (BCBS)

The Basel Committee on Banking Supervision (BCBS)—often merely referred to as 'Basel'—is a committee based within the Bank for International Settlements (BIS), from which the secretariat is drawn. It is the primary global standards-setter for the prudential regulation of banks (with the current suite of measures referred to as 'Basel III'). The BCBS represents 45 members from 28 jurisdictions, consisting of central banks and other authorities with responsibility for the supervision of banking business.

20 Q 70
21 Q 108
22 Q 1
23 Written evidence from PIMFA (FRS0009)
24 Q 121
25 Q 1
26 Written evidence from TheCityUK (FRS0041)
27 Written evidence from ABI (FRS0008)
28 Written evidence from Clifford Chance (FRS0039)
29 Written evidence from Lloyd's and the Lloyd's Market Association (FRS0028)

Representing the EU, both the European Central Bank (ECB) and the Single Supervisory Mechanism have seats, as do institutions from Belgium, France, Germany, Italy, Luxembourg, the Netherlands, Spain, Sweden, and the UK (which sends representatives from both the Bank of England and the PRA). Since the committee does not possess any formal supranational authority, its decisions do not have legal force, but members are expected to implement recommendations in a full, consistent and timely manner. The BCBS' Regulatory Consistency Assessment Programme (RCAP) monitors and assesses the implementation of these standards.

Financial Stability Board (FSB)

The Financial Stability Board (FSB) was established by the G20 at the London summit in April 2009 as a successor to the Financial Stability Forum, which had existed since 1999. The FSB is hosted in Basel by BIS, under a renewable five-year service agreement. Although it operates as an independent body, the FSB is accountable to the G20 in preparing reports. The EU sends representatives from both the ECB and the Commission, who attend alongside representatives from France, Germany, Italy, the Netherlands, Spain, and the UK—fewer EU states than are members of the BCBS. In the case of the UK, representatives come from the Bank of England, the FCA and HM Treasury.

The current Chair is Mark Carney, Governor of the Bank of England, who took over from Mario Draghi in 2011; his term is due to expire at the end of 2018. The Chair convenes and chairs meetings of the Plenary and the Steering Committee (which provides operational guidance between plenary meetings), oversees the FSB secretariat, and is responsible for representing the FSB externally. It is therefore a highly significant role.

The FSB's main remit involves coordinating policy across four priorities: building resilient financial institutions, ending too-big-to-fail, making derivatives markets safer, and transforming shadow banking into resilient market-based finance. Significantly, its mandate includes determining the list of global systemically important banks (G-SIBs). The FSB is also responsible for overseeing the policy development functions of all the international standard-setting bodies, such as the BCBS, the International Accounting Standards Board (IASB) and the International Organization of Securities Commissions (IOSCO), to improve overall institutional accountability.

International Organization of Securities Commissions (IOSCO)

The International Organization of Securities Commissions (IOSCO), established in 1983, is an association of organisations that set standards for global securities and futures markets. It incorporates the Committee on Payments and Market Infrastructures (CPMI) which works on clearing and payment systems. IOSCO works closely with the G20 and FSB, who have endorsed IOSCO standards as the relevant provisions in the area of market regulation.

IOSCO standards are used in 115 jurisdictions and there are 127 ordinary members, who are national securities commissions or similar regulators: the UK is represented by the FCA. The European Commission and European Securities and Markets Authority (ESMA) are among IOSCO's 25 associate members, along with the International Monetary Fund (IMF).

International Association of Insurance Supervisors (IAIS)

The IAIS is a voluntary membership organisation of insurance supervisors and regulators in 140 countries. Established in 1994, it is the international standard setting body responsible for developing and assisting in the implementation of principles, standards and other supporting material for the supervision of the insurance sector. It is also supported by a Basel-based secretariat.

The IAIS conducts activities through a committee system, encompassing Audit and Risk, Budget, Financial Stability, Implementation, and Technical Committees, under the direction of its Members. The European Commission is a member, as are several EU Member States; the PRA and FCA represent the UK. Victoria Saporta of the PRA is the Chair of the IAIS Executive Committee.

International Accounting Standards Board (IASB)

The International Accounting Standards Board is the standard-setting body of the IFRS Foundation (International Financial Reporting Standards). There are 17 IFRS standards produced as part of the Conceptual Framework for Financial Reporting, not all of which are directly relevant to financial services. The use of IFRS Standards is required in over 125 jurisdictions and the Standards have been incorporated into much of the EU's prudential regulation.

20. While international standards have been influential in recent years, some witnesses cautioned that this might not continue in perpetuity. Professor Ferran said there was "a question mark over whether the international standard-setting fora are losing their influence anyway, in particular as a result of the 'America First' Trump presidency. There is a risk, if the US pulls out of serious commitment to those fora, of their becoming a talking shop without real bite."[30] Indeed, the Institute of Chartered Accountants in England and Wales (ICAEW) commented that politically-motivated delays meant that Basel III "has been nicknamed 'Basel IV' by some … We can no longer take for granted an international standard that describes a consensus of best practice agreed by leading nations."[31]

21. Whatever their utility, witnesses were generally emphatic that the UK should not look to diverge from international standards. TheCityUK stated that global regulatory standards "minimise the risk of regulatory arbitrage and a 'race to the bottom' which may reduce consumer protection and increase systemic risk".[32]

22. Influencing global standards may also be valuable in mitigating the UK's loss of influence at the EU level. Mark Hoban, Chairman of the International Regulatory Standards Group (IRSG), stated that "in a post-Brexit world, that global regulatory framework becomes more important for the UK".[33] PwC argued that "playing a leading role in shaping global standards will be the best way for the UK to influence EU regulation post-Brexit".[34] Sir Jon Cunliffe commented that it would be of enduring importance to "influence the global debate"; he believed that "the Bank has a strong international reputation, and we intend to continue that and continue to invest in that".[35]

30 Q 1
31 Written evidence from ICAEW (FRS0046)
32 Written evidence from TheCityUK (FRS0041)
33 Q 28
34 Written evidence from PwC (FRS0019)
35 Q 74

The EU's regime

23. The regulatory regime for financial services at the EU level has developed apace in recent years: starting from a relatively decentralised base, where much regulatory activity fell within the purview of the Member States, it has become complex, comprehensive, and increasingly centralised.

24. Perhaps the key feature of the EU's regime is the pan-EU 'passport', which provides that "once a bank or financial services firm is established and authorised in one EU Member State, it can apply for the right to provide certain defined services throughout the EU, or to open branches in other Member States across the EU, with relatively few additional authorisation requirements".[36] According to the European Parliament, passporting "relies on two elements: i) a set of prudential requirements harmonised under EU law; and ii) mutual recognition of licences".[37] Box 2 summarises the key legislation granting passporting rights.

25. The list in Box 2 is not, however, exhaustive, as legislation granting passporting rights also covers insurance (the Insurance Mediation Directive and subsequently Insurance Distribution Directive); market infrastructure (the European Market Infrastructure Regulation, EMIR, allows clearing houses to offer services throughout the EU, and the Central Securities Depository Regulation, CSDR, does the same for central securities depositories); payment services (the second Payment Services Directive, PSD II, which applies from 13 January 2018, and the Electronic Money Directive); and mortgages (the Mortgage Credit Directive, MCD).

26. It should also be noted that there are other key pieces of the EU legislative jigsaw, which are based on international standards (such as the Bank Recovery and Resolution Directive, BRRD, which incorporates Financial Stability Board standards) that do not pertain to passporting.

Box 2: EU legislation granting passporting rights

Capital Requirements Directive (CRD IV)[38]

The Capital Requirements Directive and the accompanying Capital Requirements Regulation came into force for banks in 2013, bringing into EU law the capital adequacy standards agreed at international level in the Basel III regulations. The CRD IV regime covers banking services, including deposit taking, lending and other forms of financing, financial leasing and payment services, some corporate finance advisory services and some trading services. There is no third country regime under CRD IV.

36 British Banking Association (BBA), *What is 'passporting' and why does it matter?* Brexit Quick Brief #3: https://www.bba.org.uk/wp-content/uploads/2016/12/webversion-BQB-3-1.pdf [accessed 12 January 2018]

37 European Parliament, *Third-country equivalence in EU Banking legislation* (12 July 2017): http://www.europarl.europa.eu/RegData/etudes/BRIE/2016/587369/IPOL_BRI(2016)587369_EN.pdf [accessed 12 January 2018]

38 The CRD IV package comprises Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176/338, 27 June 2013) (CRD) and Corrigendum to Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 321/6, 30 November 2013) (CRR)

Solvency II Directive[39]

Solvency II sets the prudential framework for insurance and requires insurers to hold enough capital to have 99.5 per cent confidence that they could cope with the worst expected losses over a year. It allows an EEA firm to provide insurance or reinsurance services either cross-border or by establishing a branch in another state. Third-country insurers can provide services by establishing a branch within the EEA, authorised in the Member State in which it is established. A third-country equivalence regime exists under Solvency II for reinsurance but not for direct insurance

Markets in Financial Instruments Directive (MiFID)[40]

MiFID has been applied in the UK since 2007 and was recently revised. MiFID II and the accompanying Markets in Financial Instruments Regulation (MiFIR) came into force on 3 January 2018, although elements of the implementation have been delayed.[41] Under the MiFID regime, banks and investment firms can passport services related to securities, funds and derivatives, including trade execution, investment advice, underwriting and placing of new issues and the operation of trading facilities. MiFIR introduces a third-country regime, allowing firms from third countries to offer these services cross-border to wholesale customers and counterparties.

Undertakings for Collective Investment in Transferable Securities (UCITS) Directive[42]

The UCITS regime has been in place since 1985 and was most recently updated in 2014. Investment funds that meet the rules set out under the UCITS Directive may be sold freely, including to retail investors, throughout the EEA on the basis of single national authorisation. There is no third-country regime under UCITS, so were the UK to become a third country UK-based asset managers wishing to continue marketing these products would have to re-domicile—though there could be scope for a redomiciled management company to delegate day-to-day management of the fund back to the UK. Alternatively, funds could be marketed to the EU from the UK as alternative investment funds (AIFs).

39 Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (OJ L 335/1, 17 November 2009) (Solvency II)

40 The MiFID II package comprises Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (OJ L 173/349, 12 June 2014) (MiFID II) and Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012 (OJ L 173/84, 12 June 2014) (MiFIR)

41 ICE Future Europe and the London Metal Exchange were granted 30-month extensions by the FCA and Eurex was likewise granted a delay by BaFin. ESMA have also delayed publishing the list of equities to be excluded from trading in dark pools for three months, pending further technical work.

42 Directive 2014/91/EU of the European Parliament and of the Council of 23 July 2014 amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depositary functions, remuneration policies and sanctions (OJ L 257/186, 28 August 2014) (UCITS)

Alternative Investment Fund Managers Directive (AIFMD)[43]

The AIFMD sets the rules for alternative investment fund managers. It created an EEA-wide passport for EEA fund managers to market those funds across the EEA. A national private placement regime (NPPR) exists to allow non-EEA fund managers to market funds in EEA jurisdictions to professional investors, depending on the specific rules in those jurisdictions. AIFMD envisages that the NPPR will be phased out: it does, however, contain third-country equivalence provisions, which could enable UK firms to market their funds.

Source: European Union Committee, Brexit: financial services (9th Report, Session 2016–17, HL Paper 81)

27. Evidence from the UK financial services industry expressed broadly favourable views of the EU regime. UK Finance, a pan-industry group representing nearly 300 firms providing finance, banking and payment services in the UK, stated that "the EU financial services regime, including its single rulebook, macro prudential, micro prudential and financial conduct framework has contributed significantly to the stability of the banking sector and the financial system in the UK and supports long term economic growth".[44] Barclays affirmed that "the breadth and depth of regulation has, over the years, created an environment that promotes stability, ease of cross-border activity, and economic growth".[45] Lloyd's told us: "Our overall assessment of the EU's financial services regime, in light of its application to the UK's non-life insurance and reinsurance sector, is broadly positive."[46]

28. As KPMG put it, "The EU's current financial regulatory regime reflects three main drivers: application of commitments to global standards (most notably from the FSB, Basel Committee, IAIS and IOSCO); regulation to facilitate the operation of the Single Market; and rules to meet the specific needs of European financial markets where global standards do not exist."[47] A key impetus in recent years has been the need to shore up the financial services sector after the financial crisis, which led to a suite of EU legislative proposals, and the creation of the European Supervisory Authorities (ESAs) in 2011.[48] According to Barnabas Reynolds, Head of the Global Financial Institutions Advisory & Financial Regulatory Group at the law firm Shearman & Sterling, another factor was that "a lot of rule-making in recent times has been focused on propping up the euro project".[49]

43 Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 (OJ L 174/1, 1 July 2011) (AIFMD)
44 Written evidence from UK Finance (FRS0044)
45 Written evidence from Barclays (FRS0040)
46 Written evidence from Lloyd's and the Lloyd's Market Association (FRS0028)
47 Written evidence from KPMG (FRS0043)
48 See European Union Committee, *The post-crisis EU financial regulatory framework: do the pieces fit?* (5th Report, Session 2014–15, HL Paper 103). Appendix 4 of that report provides an overview of the major legislative reforms undertaken at the EU level post-crisis. As the report summarises, some reforms, such as the Capital Requirements Directive (CRD) and Capital Requirements Regulation (CRR)—jointly known as CRD IV—and the European Market Infrastructure Regulation (EMIR), are closely associated with the G20 agenda. Others, such as the Alternative Investment Fund Managers Directive (AIFMD), reflect the EU's own agenda. Some concern reforms to existing legislation, such as the revised Markets in Financial Instruments Directive (MiFID II) and Regulation (MiFIR). Finally, there are EU-specific institutional reforms, such as the Banking Union framework and the establishment of the European Supervisory Authorities (ESAs).
49 Q 13

29. Many of our witnesses felt that the recent period of intense EU rule-making was approaching its end. Current projects being undertaken by the EU include Capital Markets Union (CMU),[50] shoring up the Banking Union, and the review of ESAs. Professor Niamh Moloney believed that the EU was now in:

> "A steady-state procedure, so it is hard to see where the big new ideas would come from. The grand projects have been dealt with. We will see tinkering with banking union and finishing Capital Markets Union, but we will not see a big project over which there would be political contestation."[51]

Andrew Bailey stated that from the perspective of UK implementation, "we are coming towards the end of what I might call the post-financial crisis regulatory reform agenda. We have a lot of big implementation on our hands in the next month or so, particularly with MiFID II. The pipeline does not look anything like as big as that, going forward."[52]

30. We heard competing assessments of the future of CMU in the wake of the UK's withdrawal. TheCityUK noted that CMU "could lose momentum in the short to medium term", but added that "it is widely acknowledged that Brexit has only increased the need for this project to succeed".[53] The Confederation of British Industry (CBI) emphasised the UK's "central role in the development of the CMU" (including the role of former UK Commissioner Lord Hill of Oareford).[54] The EU has already announced initiatives such as a review of AIFMD, to be conducted under the auspices of the CMU project, which may have a bearing on the UK post-Brexit.

31. There are also significant legislative reviews currently taking place of the EU's regulatory framework. These include measures on banking regulation (the Capital Requirements Directive and Regulation, CRD and CRR, and the Banking Recovery and Resolution Directive, BRRD) and the European Market Infrastructure Regulation (EMIR), most notably containing the possibility of imposing a location policy on systemically important central counterparties (CCPs).

32. On the current timetable, it appears that the UK will be part of negotiations on these initiatives, although its influence is waning. All will have important ramifications on the UK market: Deloitte's written evidence argued that the EU's proposals for the CRD "demonstrated a growing willingness to depart from implementing global post-crisis banking rules", in particular by discounting risk weights derived from the fundamental review of the trading book (FRTB) by 35% for the first three years of application.[55] The EMIR review is, as we have noted, a matter of concern for the clearing industry.

International standards and the EU

33. As we have noted, a number of EU rules derive from international standards and Neena Gill MEP portrayed the EU's regime as proceeding "in line with

50 On which, see European Union Committee, *Capital Markets Union: a welcome start* (11th Report, Session 2014–15, HL Paper 139)
51 Q 2
52 Q 100
53 Written evidence from TheCityUK (FRS0041)
54 Written evidence from the CBI (FRS0025)
55 Written evidence from Deloitte (FRS0016)

minimum standards set on the international level".[56] Nonetheless, the high-level principles contained in international standards are not always transposed entirely faithfully into the EU's own statute book; as Professor Eilís Ferran told us, "they are a starting point and EU regulation often comes out in a rather different form". She gave the example of the IOSCO standards:

> "They are quite high level and aim to be principles-based to set a standard that different jurisdictions can adhere to. If we compare that with the way in which the EU has imposed regulation on financial benchmarks, the EU has taken heed of international standards but has put in place a much more formalised regulatory regime requiring authorisation and registration, so there is quite a difference in the level of granularity between the two."[57]

34. Barclays referenced the implementation of Basel III standards, where the UK had gone first, while "the EU is still in the process of implementing many standards and is proposing derogations from the Basel standard in areas such as the fundamental review of the trading book (FRTB) or Net Stable Funding Ratio (NSFR)".[58] Indeed, the EU's prudential framework was in 2014 found by the Basel Committee to be 'materially non-compliant' with Basel standards.[59] But while the EU regime is not always fully at one with international standards, Sir Jon Cunliffe's summary was positive: "There have been some things that we have not necessarily agreed with … However, when you look at the international standards where they exist and how the EU has implemented them, it has been high quality."[60]

35. Not all EU legislation flows from an international source. Sir Jon commented: "There is a lot of EU legislation in areas where there are not international standards, particularly in the market finance area—so legislation on hedge funds and the like."[61] TheCityUK criticised asset segregation rules in the Alternative Investment Fund Manager Directive (AIFMD) and Undertakings for Collective Investment in Transferable Securities (UCITS), and the Short Selling Regulation (SSR) on trading practices, as areas where the EU has taken unwelcome action, commenting that "the overlap of these pieces of legislation are a central cause of the reduced liquidity in the market but critically are not based on international standards".[62]

36. There are also differences in the way that Member States transpose and operate EU law. According to Neena Gill MEP, "The UK is often accused of 'gold plating' by adding layers on top of European regulation, in order to adapt to the specific UK context."[63] TheCityUK's evidence particularly singled out MiFID and MiFID II as examples of these practices.[64] Gold-plating is often used as a pejorative term, and evidence from Zurich, the insurance group, correspondingly argued that "UK regulation is in many cases at a level that substantially exceeds international 'norms' and it is

56 Written evidence from Neena Gill MEP (FRS0013)
57 Q 1
58 Written evidence from Barclays (FRS0040)
59 Bank for International Settlements, *Regulatory Consistency Assessment Programme (RCAP) Assessment of Basel III regulations: European Union* (December 2014): https://www.bis.org/bcbs/publ/d300.pdf [accessed 12 January 2018]
60 Q 70
61 Q 70
62 Written evidence from TheCityUK (FRS0041)
63 Written evidence from Neena Gill MEP (FRS0013)
64 Written evidence from TheCityUK (FRS0041)

evident that the UK implementation of Solvency II by the PRA, has in some instances, resulted in a framework which is more complex and costly than necessary”.[65]

37. However, we also heard evidence that the UK’s practices of going beyond core requirements had often been effective: the assessment of the Financial Services Consumer Panel was that “the Government and FCA have often chosen to go beyond the minimum requirements of EU Directives” in order to resolve problems and “generate better consumer protection”.[66] Charlotte Crosswell of Innovate Finance praised the UK’s history of innovating upwards on standards, commenting: “In the UK, we have a history of gold-plated standards. We have often led the way in asking people to adhere to higher standards than before.”[67] Barnabas Reynolds, who was generally of the opinion that the UK should return to operating “higher standards with fewer rules”, was nonetheless unequivocal that “we should not get rid of the gold-plating”.[68]

38. While the UK has a history of over-implementation, Dr Kay Swinburne MEP told us in December 2017 that “17 member states do not even have the directive part of MiFID transposed into their national statute”—a fact she found “quite shocking”.[69] The EU regime is therefore not uniformly implemented. The Financial Services Consumer Panel made a related point, suggesting that a “weakness of the EU regime has been a lack of consistent supervision across Member States. Regulatory expertise and resources across the EU28 vary greatly”, which in turn “creates risks for all consumers and undermines trust in the market, especially for passported products.”[70]

39. Furthermore, Professor Moloney stated that by virtue of its decision-making process, the EU’s policies may not always be optimal. One benefit of Brexit may be “a breakaway from groupthink about financial regulation. The EU is a monolith and it has big structures designed to produce compromise positions. That is not necessarily good for the global financial governance system”.[71]

The distinctiveness of the UK’s regime

40. In the wake of the financial crisis, the UK has been subject to a more developed regime at the international and EU levels. However, it has also had scope to initiate domestic legislation. Professor Niamh Moloney commented: “The UK has developed independently very sophisticated rules on banking accountability, in the Banking Act [2009], for example. All of those are distinct from what the EU has done.” She concluded that “the ethical/accountability framework … along with consumer protection” was being led at UK level.[72]

41. Jonathan Herbst, a Partner at the law firm Norton Rose Fulbright, highlighted a similar example: “The Senior Managers Regime, which is an entirely UK-created regime. Other countries have not followed it. No one

65 Written evidence from Zurich Insurance (FRS0042)
66 Written evidence from the Financial Services Consumer Panel (FRS0024)
67 Q 95
68 Q 13
69 Q 141
70 Written evidence from the Financial Services Consumer Panel (FRS0024)
71 Q 9
72 Q 3

seems to have a problem with that."[73] The ICAEW also praised the regime, commenting that "The UK's Senior Managers Regime (SMR)[74] has brought positive change in banks and their culture. It has brought a statutory and regulatory focus on individuals working in financial services firms." The SMR shows the UK going beyond international or EU standards, which it is entitled to do within the bounds of the supranational regulatory framework. In such areas the UK can be a role model: the ICAEW noted that "other jurisdictions are observing how effective SMR proves to be and may seek to emulate it in due course".[75]

42. The UK is also an international leader in FinTech, an area in which the EU is not much involved. Andrew Bailey commented that "FinTech, interestingly, is very little subject to regulation at the moment, and that is a good thing".[76] Flora Coleman of TransferWise noted that the regulatory sandbox,[77] introduced as part of the FCA's Project Innovate, was "being used to allow existing firms to try to push the boundaries of regulation in a highly supervised environment";[78] according to PwC, it had "demonstrated the FCA's greater commitment to flexibility and supporting innovation compared to other regulators". Rachel Kent, a Partner at the international law firm Hogan Lovells, also pointed to the sandbox, as well as the Bank of England's regulatory accelerator, as evidence of the possibility of divergence within the existing regulatory system: "All those things have happened or continue to happen within our existing regime."[79]

43. While the UK currently possesses a degree of autonomy in FinTech, which it uses to put in place innovative supervisory practices, there is the potential for EU intervention: Karel Lannoo, Chief Executive of the Centre for European Policy Studies, told us that "The EU is now working on a regulatory approach to FinTech. Is it needed? I do not know. It is a very limited industry size-wise."[80] Future EU activism in the area of FinTech may result in a more standardised regulatory regime being implemented within Europe; this may have future implications for the UK's current supervision-led approach, depending on the outcome of decisions taken regarding future market access. There would be a risk to this industry if an agreement were to be reached that left the UK a rule-taker.

The UK's role in shaping standards

44. The UK has played a significant role in shaping regulatory standards in financial services at both the international and EU levels. A report published

---

73 Q 15

74 The FCA's Senior Managers and Certification Regime replaced the Approved Persons Regime (APR) for banks, building societies, credit unions and dual-regulated (FCA and PRA regulated) investment firms in March 2016. The most senior people ('senior managers') performing key roles ('senior management functions') need FCA approval before starting their roles. Every senior manager needs to have a 'statement of responsibilities' that clearly says what they are responsible and accountable for. See Financial Conduct Authority, 'Senior Managers and Certification Regime: banking' (November 2017): https://www.fca.org.uk/firms/senior-managers-certification-regime/banking [accessed 19 January 2018]

75 Written evidence from ICAEW (FRS0046)

76 Q 105

77 The regulatory sandbox allows approved firms to test innovative business models without immediately incurring regulatory consequences, while remaining under close supervision by the FCA. Firms must apply to join the initiative; three application rounds have so far been held with the third cohort of firms announced in December 2017.

78 Q 95

79 Q 30

80 Q 133

in 2016 by the City of London Corporation and Norton Rose Fulbright, based on interviews with key participants in the negotiations, found that the UK had exercised significant influence over the final form of legislation such as Solvency II, AIFMD, EMIR, CRD IV and MiFID II.[81]

45. Professor Niamh Moloney reminded us that following Brexit the UK would lose access to many of the institutions through which it has hitherto exercised influence: "Those formal channels are the Commission, the European Central Bank and the European Supervisory Authorities that to a different extent sit on those bodies."[82] But the UK's loss of access will also diminish those institutions themselves. As Mark Hoban, the former City Minister, commented, "The UK's voice in ECOFIN on financial regulation was listened to because we have authority, expertise and a set of skills and experiences that others find it hard to replicate."[83] Daniel Maguire, Chief Executive of LCH, concluded: "It is imperative that the authorities of the UK sit at those tables and shape and influence the global regulation for these markets" post-Brexit.[84]

46. There have, though, been a few failures of UK influence at the EU level. One of the most notorious concerned remuneration rules in CRD IV, which impose a bonus cap for bankers. Deloitte noted that the UK had opposed this measure, on the grounds that it "fails to link risk-taking with variable remuneration, increases fixed pay at banks and consequently makes those banks less able to reduce their salary costs in times of stress, potentially contributing to financial stability risks."[85] Indeed, Karel Lannoo suggested that the UK might wish to take advantage of Brexit to change bonus rules,[86] something that the Bank of England Governor, Mark Carney, has also hinted at.[87] (The EU, however, has suggested that any equivalence ruling may be subject to the maintenance of such caps.[88]) The UK also opposed, without success, the Short Selling Regulation (SSR), on which, as the CBI noted, "the UK raised an objection in relation to the enforcement powers granted to ESMA".[89]

47. Despite these occasional failures, the point stands that the UK has exercised significant influence as an EU Member State. In the absence of the UK, it is possible that the direction of EU legislation could shift. The ICAEW argued that "The UK, along with the Dutch, have been cited as the voice of 'moderation' at the EU 'table'. There is now the risk that more polar views, or those that favour one or a small number of nations may be advanced."[90] UK Finance added that the "UK's participation in negotiations has helped to

81 City of London Corporation, *Shaping legislation: UK engagement in EU financial services policy-making* (June 2016): https://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Documents/research%202016/shaping-EU-legislation-2.pdf [accessed 12 January 2018]
82 Q 1
83 Q 28
84 Q 55
85 Written evidence from Deloitte (FRS0016)
86 Q 133
87 Caroline Binham, 'Bankers' bonus cap could be scrapped after Brexit, says Carney', *Financial Times* (29 November 2017): https://www.ft.com/content/dea0611c-d51c-11e7-a303-9060cb1e5f44 [accessed 12 January 2018]
88 Jim Brunsden, 'Brussels signals tough stance on UK bank bonuses after Brexit', *Financial Times* (19 December 2017): https://www.ft.com/content/98c9a2b4-e4a0-11e7-97e2-916d4fbac0da [accessed 12 January 2018]
89 Written evidence from CBI (FRS0025)
90 Written evidence from ICAEW (FRS0046)

avoid many of the unintended consequences that might otherwise flow from the lesser and more fragmented experience of financial markets regulation that exists elsewhere in the EU".[91] The future direction of the EU's regulation may, therefore, become less fit for purpose for UK institutions than in the past.

48. Jonathan Herbst questioned "the popular perception … that the institutions of the EU will go in a more statist direction". But, he added, "One of the big questions … is whether there will be enough expertise and market knowledge to do the job."[92] Simon Gleeson, a Partner at Clifford Chance, concurred, warning of what he called a "chained to a corpse issue",[93] if EU regulation did not keep pace with market developments, but the UK was required, under the terms of a free trade agreement, to ensure regulatory alignment (see Chapter 5).

49. International engagement will thus become even more crucial in future. In the words of Mark Hoban: "Once we are outside the EU, we will not have that opportunity to shape what happens in Brussels to the same extent, so the coherence of the global framework becomes important."[94] Sally Dewar of JP Morgan agreed: "The UK's engagement and co-operation at international level is going to be even more important."[95] The London Metal Exchange also argued that, in the domain of financial market infrastructure, the most important factor would be "the convergence of UK and EU supervisory standards through the implementation of global standards."[96] Sir Jon Cunliffe commented on the Bank's continued investment in shaping global regulatory work: "We need those standards; we need the strongest international governance relationships."[97]

50. The UK has to date been influential in defining the international agenda at the highest levels, in particular through the work of the Governor of the Bank of England, Mark Carney. Mark Hoban, now Chair of the IRSG, commented "the UK plays a significant role in the shaping of global regulation as well as European regulation, and Mark Carney's chairmanship of the FSB is a sign of that."[98] Andrew Bailey concurred: "The work that has been done by the G20 and the Financial Stability Board, which Mark Carney chairs, has been fundamental in putting stronger global standards in place."[99] Governor Carney's term with the FSB has been extended until November 2018, with the ICAEW noting that he will also chair "two key BIS central bank groups … the Global Economy Meeting (GEM) and the Economic Consultative Committee (ECC)".[100]

51. UK regulators have exercised technical influence over international organisations across a range of policy fields: as PIMFA noted, "Having UK regulators in positions of influence, in chairing global standard-setter working parties, groups and committees, and in exporting good regulatory thinking in their role as ordinary committee members, will be paramount

91 Written evidence from UK Finance (FRS0044)
92 Q 15 (Jonathan Herbst)
93 Q 15 (Simon Gleeson)
94 Q 28
95 Q 86
96 Written evidence from the London Metal Exchange (FRS0048)
97 Q 74
98 Q 28
99 Q 102
100 Written evidence from PIMFA (FRS0009)

… For instance, the FCA chairs IOSCO's asset management work."[101] With respect to insurance, Lloyd's commented: "UK supervisors are very active in the IAIS's committee structure … and ensure that the IAIS's views on regulation reflect experience in the EU."[102] The UK will need to continue to provide expertise across all tiers of international organisations in order to continue to retain influence.

52. Witnesses expressed concerns over the UK's continued ability to exercise such influence in the future. In particular, change at senior levels in the regulators is expected: Mark Carney has announced his intention to step down from his role at the Bank of England in June 2019, while the first terms of appointment of Sir Jon Cunliffe, and of Ben Broadbent, Deputy Governor for Monetary Policy, expire in October 2018 and June 2019 respectively. Sir Jon Cunliffe assured us that "continuity in the Bank's leadership" was "a very important issue in the Bank".[103] He also said that succession planning was a key issue for the Treasury, a point echoed by the Minister: "There are always times when senior figures change within institutions, but it is something we are alive to."[104] HM Treasury should make and communicate decisions regarding the occupancy of such senior appointments at the earliest possible opportunity.

53. Clearly, Government and regulators will need to be mindful of how domestic policies can contribute to a strengthened international presence. It is notable that, as Sam Woods told us, the PRA has imposed an additional levy to meet the demands of Brexit;[105] the FCA have similarly increased their fees by £2.5 million this year.[106] Regulators will need to address the challenges posed by withdrawal and will likely require yet further resources in order to do so.

Conclusions and recommendations

54. **UK regulators have been highly influential at both technical and political levels within the international standards-setting bodies. The backbone of this engagement is personnel: without the right people in place, the UK will not be able to exercise the same clout. It is important that the UK's financial services industry is reassured that regulators are adequately resourced and supported. The Government should, furthermore, take decisions about key leadership positions as early as practicable.**

Risks of divergence from international standards

55. The financial services industry is concerned about the disruption that Brexit may cause to its business models and markets. From the perspective of regulation and supervision, however, the concern is ultimately whether withdrawal poses critical risks to financial stability. Sir Jon Cunliffe put this starkly: "What is important for us is financial stability. We are responsible for financial stability for probably the largest international financial centre

101 Written evidence from PIMFA (FRS0009)
102 Written evidence from Lloyd's and the Lloyd's Market Association (FRS0028)
103 Q 76
104 Q 118
105 Q 76
106 Emma Haslett, 'Brexit will cost the financial regulator £2.5m this year', *City A.M.* (18 April 2017): http://www.cityam.com/263030/brexit-cost-financial-regulator-25m-year [accessed 16 January 2018]

in the world. It is 10 times GDP, and openness—and openness in financial services—can be and often is a good thing."[107]

56. In the wake of the 2008 financial crisis, there were initiatives at the global and subsequently EU level to enshrine reforms that sought to prevent crises from re-occurring. Sir Jon Cunliffe summarised the scope of the reforms:

> "The international standard-setting process existed for banks before the crisis. It now exists in a much deeper, more powerful way for banks, and for other areas of the financial sector: financial market infrastructure and the like. This whole idea of international financial stability is really what is at the heart of the Financial Stability Board, which tries to pull it together and push global standards."[108]

He concluded that "international standards have made a very substantial contribution to reinforcing the system against those sorts of risks",[109] particularly in bolstering bank capital requirements and routing the clearing of derivatives contracts through CCPs.

57. Given the development of these post-crisis standards, there is a risk that Brexit could be used by the UK or the EU as an opportunity to row back on some of the commitments made as part of the post-2008 global reforms. The possibility of the EU instituting a location policy for CCPs, which would go against the grain of the 2009 G20 Pittsburgh commitments, was highlighted by our witnesses as a particular risk to financial stability, as it would cause the fragmentation of liquidity. Daniel Maguire, Chief Executive of the London Clearing House (LCH), stated:

> "If you go down the route of fragmentation, you could have many pots of the same risk in many different jurisdictions, all trying to come in. You could have longs in one CCP, shorts in another, and so on. It can become very unwieldy. Going back to the G20 commitment thing, it is about safety, soundness and financial stability. The market is choosing that it is better in one place. The risk managers and the systemic risk managers think the same."[110]

58. Brexit is being viewed on both sides of the channel as a threat to the financial stability the UK and EU have sought to embed. Sir Jon Cunliffe got to the nub of the issue: "Financial stability risk, to me, is about how institutions in one jurisdiction are exposed to another."[111] Supervising financial institutions within a more fragmented market will, for example, inevitably become more difficult and will rely on trust and cooperation.

59. Stephen Jones of UK Finance believed that if UK supervisors were "to take on the supervision of one large continental European bank's £700 billion branch balance sheet in the UK, to do so without having undertaken the appropriate local supervisory protective measures could be seen as irresponsible".[112] Simon Gleeson stated that EU supervisors were also cautious about their ability to supervise institutions in their jurisdictions: "Europe has exactly the same view as the UK regulators on this. It will not allow brass plates;

107 Q 67
108 Q 74
109 Q 74
110 Q 52
111 Q 75
112 Q 45

it wants to see real capital, real people and real business."[113] Fragmentation may undoubtedly create threats to stability, especially if underpinned by divergences from the international framework.

Conclusions and recommendations

60. **The UK's domestic regime for the regulation of financial services is largely, and increasingly, shaped by the context of international standards and EU law. The UK has been highly influential in shaping the form of supranational regulation, both at the international and EU levels. The UK has also shown leadership in areas of regulation in which it is not constrained by international standards, such as conduct and FinTech; these measures have subsequently served as models for other countries to follow. While leaving the EU may provide opportunities for the UK to tailor its regulation to domestic needs, such opportunities will be necessarily constrained by the UK's continued participation in international fora.**

61. **It is imperative that the UK continues to devote sufficient resources to engagement with international standards-setters. The Government should continue, as a minimum, to adhere to international standards, and to work vigorously to shape them in future, especially if there is a risk of them being undermined by other states. It is crucial that such standards remain the base of the UK's domestic regime, and that the UK acts to ensure that they are properly implemented worldwide.**

62. **The Government should also seek to develop new international relationships, to fortify the extant engagement taking place within formal standards-setting bodies and more broadly. This may include considering ways in which further cooperation can be sought within a bilateral context, including setting up joint fora to monitor regulatory developments. Embedding a network of global cooperation via these means could help to synchronise standards within and beyond the EU.**

63. **Post-crisis changes have served to promote financial stability and the Government should continue to advocate these reforms. This is especially the case if faced with initiatives by the EU that in fact lead to market fragmentation and a reversal of the post-crisis commitments—such as is the case with current proposals that would potentially require CCPs to relocate within the EU.**

113 Q 11

CHAPTER 3: INCORPORATING THE EU *ACQUIS* IN FINANCIAL SERVICES

The EU (Withdrawal) Bill

64. The Government seeks to translate existing EU legislation into domestic law by means of delegated legislation, using powers set out in the European Union (Withdrawal) Bill. Stephen Barclay MP, the City Minister, summarised the Government's approach: "We have been very clear that we are not looking to make policy changes. In essence, it is a cut and paste of the status quo. We are not seeking to deregulate."[114]

65. While a 'cut and paste' approach may appear straightforward, the sheer scale of the process and the associated costs should not be underestimated. As TheCityUK commented: "The task of separating UK law from EU law has widely been recognised as the biggest legislative challenge the UK has ever faced, involving the translation of over 12,000 EU regulations into UK law and the adaptation of 7,900 statutory instruments which implement EU legislation."[115] This process poses particular challenges in the field of financial services. In the words of Stephen Jones of UK Finance: "It is an enormously complex piece of legislation that is required: essentially, the adoption of the *acquis* into English law. I believe there are 10,000 pages of EU originated financial services rules and, frankly, there is very little time."[116]

66. The evidence from the financial services industry revealed broad support for the Government's approach. Catherine McGuinness, of the City of London Corporation, said that "the key concern … is for clarity, certainty and stability, and just knowing that there are not going to be tweaks and changes—that we are going to be faced with where we are at the moment, and then we can move forward".[117] The Association for Financial Markets in Europe (AFME) also welcomed the Bill, and expressed support for "the objectives of clarity and continuity".[118]

67. Despite the industry's support for the Bill, AFME highlighted "a number of important challenges and issues".[119] Simon Lewis, Chief Executive of AFME, stated: "The sheer complexity of the EU (Withdrawal) Bill should not be underestimated, and I know that some of the regulators within the community are having to beef up their legal teams just to think about how they can understand the implications of what needs to be delivered."[120] The devil will lie in the detail.

Incorporating the Lamfalussy framework

68. Within the EU regulatory process in financial services, the 'Lamfalussy process' or 'Lamfalussy architecture' (named for Alexandre Lamfalussy, the Chair of the committee that created it) prevails. The process was first initiated in 2001, and amended in 2011 when the European Supervisory

114 Q 117
115 Written evidence from TheCityUK (FRS0041)
116 Q 36
117 Q 25
118 Written evidence from AFME (FRS0021)
119 Written evidence from AFME (FRS0021)
120 Q 36

Authorities (ESAs) came into being.[121] The Lamfalussy architecture, outlined in Box 3, was designed to allow for the swift amendment of what is often highly technical legislation.

Box 3: The Lamfalussy architecture: level 1, 2, 3, and 4 financial services regulation

The Lamfalussy architecture consists of four regulatory 'levels', all of which sit within the EU's secondary law. The most significant is level 1, the ordinary legislative procedure, wherein the European Parliament and Council adopt laws (basic acts, either Directives or Regulations), which have been proposed by the Commission. Level 2 measures derive from provisions contained in basic acts that empower the Commission to adopt non-legislative delegated or implementing acts. These often set technical standards, on which the Commission consults the ESAs (in the case of Binding Technical Standards, the ESAs propose them for adoption by the Commission). Level 3 measures involve the ESAs issuing guidance on a comply-or-explain basis. Level 4 encompasses supervision enforcement by the ESAs and the Commission.[122]

Parliamentary scrutiny is built into the process: level 1 legislation is agreed by the co-legislators, the Council of Ministers and the European Parliament; level 2 technical standards are subject to a range of scrutiny processes according to whether they are delegated acts (under Article 290 TFEU) or implementing acts (under Article 291 TFEU). Under Article 290 the Council and European Parliament may block or revoke (by qualified majority and majority respectively) the Commission's proposed acts; the act comes into force only if no such objection is expressed. Implementing acts are scrutinised via the examination procedure and the advisory procedure, both of which involve scrutiny by committees made up of representatives of the Member States' finance ministers and a chair from the Commission. Under the examination procedure, the committee delivers a binding opinion by way of a qualified majority; under the advisory procedure the opinions are non-binding, and a simple majority vote is sufficient.

Source: Slaughter and May, Introduction to the legislative processes for European Union directives and regulations on financial services matters (April 2014): https://www.slaughterandmay.com/media/1934583/introduction-to-the-legislative-processes-for-european-union-directives-and-regulations-on-financial-services-matters.pdf [accessed 12 January 2018]

69. Level 1 measures, as defined in the Lamfalussy framework, are a legally highly significant and far-reaching, but numerically small, component of EU law. The number of level 2 measures is, by contrast, very large,[123] encompassing a body of law that may be less easily translated into the UK's statute book. Moreover, there are a number of instruments below level 2, as the ESAs are empowered as a part of level 3 measures to produce non-binding guidance and Q&As that clarify the operation of level 1 texts. These Q&As can often

121 The three ESAs are the European Securities and Markets Authority (ESMA), the European Insurance and Occupational Pensions Authority (EIOPA), and the European Banking Authority (EBA) (which replaced a previous structure of Committees manned by national supervisors). Many of our previous reports cover the ESAs: for the most recent, see European Union Committee, *The post-crisis EU financial regulatory framework: do the pieces fit?* (5th Report, Session 2014–15, HL Paper 103).

122 See Financial Conduct Authority, A *brief guide to the European Union and its legislative processes* (June 2011): https://www.fca.org.uk/publication/archive/european-union-legislative-process.pdf [accessed 19 January 2018]

123 European Commission Directorate-General for Financial Stability, 'Financial Services and Capital Markets Union, Overview/Planning Level 2 legislative measures in the area of financial service' (11 December 2017): https://ec.europa.eu/info/sites/info/files/overview-table-level-2-measures_en.pdf [accessed 12 January 2018]

have quite significant effects, leading the Financial Markets Law Committee to state, in a response to the Commission's recent consultation on the ESAs, that the process is "characterised by a substantial element of practical and procedural uncertainty, which could be detrimental to participants in the markets supervised by the ESAs".[124] This uncertainty, inherent in the Lamfalussy framework, compounds the difficulty of translating the EU *acquis* into domestic law. As Professor Eilís Ferran said: "It is not at all clear what happens to the non-binding guidance that is given by the European Supervisory Authorities at the moment."[125]

70. The City Minister, Stephen Barclay MP, explained the Government's approach:

> "I would break it down by saying that within the levels of legislation in Europe, levels 1 and 2 will clearly be for the scrutiny of Parliament, and levels 3 and 4—the technical standards—will be within the remit that the regulators already have under the guidance."[126]

Challenging this neat division between levels, however, the Investment Association commented that "much of EU law, even at level 1, is at a level of detail that, if a domestic initiative, would be within the powers and responsibilities of the regulators".[127] The Building Societies Association was therefore concerned that the Government's approach of translating level 1 law by means of domestic delegated legislation could encode an unwieldy structure: "Without considering how that *acquis* can be updated in future, the Bill will perpetuate one of the main defects of the current EU position, namely that too much detail is in legislation and is difficult to update."[128] Simon Gleeson also reflected on this point, commenting that many significant EU measures are contained in level 1 legislation:

> "When we translate that into UK law, if we simply copy Europe … we will be moving into our primary legislation stuff that properly belongs in regulators' rulebooks … If we take a bunch of regulatory material that, almost by its nature, should be reasonably dynamic, and hard-bake it into statutory instruments, we are creating a monstrous procedural problem for ourselves in how we regulate the market."[129]

Unknowns and inoperables

71. While the Government's approach of incorporating the *acquis* via the Bill may be correct, many details are still unclear. Certain elements of the EU framework are not immediately transposable, and are referred to as 'inoperables'. The most obvious inoperable is the exercise of powers by the ESAs, which will need to be transferred to the PRA and FCA. As Stephen Jones told us, "amending the inoperables" means that "where jurisdiction cannot any more be held by European agencies, it needs to be transferred

124 Financial Markets Law Committee, *Issues of legal uncertainty arising in the context of the used of Q&A documents by the European Supervisory Authorities: response to the European Commission's public consultation on the operations of the European Supervisory Authorities* (May 2017): http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_response_to_european_commission_consultation_on_the_operation_of_the_european_supervisory_authorities.pdf [accessed 12 January 2018]

125 Q 6

126 Q 118

127 Written evidence from the Investment Association (FRS0029)

128 Written evidence from the Building Societies Association (FRS0010)

129 Q 12

to an equivalent UK agency—we have to address that".[130] This is, however, perhaps the most straightforward part of the exercise. As Mr Jones went on to explain, "there are relatively few instances where there is not an immediate and obvious UK equivalent to replace a European authority that currently sits as an arbiter of the EU".[131]

72. There are various other, more complex, inoperables. A key concern is what is often called 'in-flight' legislation, which is legislation that has been agreed but that has not fully entered into force before the point at which the UK leaves the EU. Professor Ferran elaborated this point: "We are going to convert EU law that is in force and applicable as at [the date of withdrawal]. Satisfying the law 'in force and applicable' requirement is potentially problematic if we have staggered starts to EU regulation, and we have not already completed the process of writing all the technical rules. That will give rise to legal uncertainty."[132] Andrew Bailey responded that "the clear rule of engagement up to March 2019 is that we are implementing EU legislation and EU rules", and that "the same position holds for level 2 and level 3", but that the ultimate status of legislation coming into force after that point "depends on agreement on a transition and whatever future agreement the UK Government reach with the EU".[133]

73. A further issue concerns agreements with third countries. Richard Knox, of HM Treasury, said that "as the UK ceases to be an EU member state, the access privileges and rights with third countries by dint of being a member state fall away. We have systematically gone through … them and our intention is to provide continuity for industry to allow those access rights to continue." He added: "There are a large number of agreements, I think 300 or so."[134] Simon Gleeson, however, questioned the status of these agreements during any transition period: "You do not just need an interim period with Europe; you also need an interim period with all the third countries that currently have equivalence and similar arrangements with Europe, so that they can put those in place with the UK before you get to the end."[135]

74. Mr Gleeson also suggested that "the biggest thing" missing from the Bill was "the position of European businesses in the UK. Although transporting European law into the UK is easy, working out what we do domestically is a whole new issue."[136] The current scale of cross-border business is significant: Neena Gill MEP noted that 8,008 EU/EEA companies hold a total of 23,532 passports to do business in the UK.[137] The Loan Market Association, which represents over 666 commercial and investment banks, institutional investors, law firms, service providers and rating agencies involved in the syndicated loan market, observed that in 2016, UK banks provided €46.4 billion in syndicated loans to borrowers in the EU-27; during the same period, EU banks funded €41.5 billion for UK borrowers.[138]

75. Sam Woods explained that a major issue for the PRA was "the inbounds. We have 160 branches here—about 75 banks and 85 insurance companies—

130 Q 36
131 Q 36
132 Q 6
133 Q 100
134 Q 122
135 Q 13
136 Q 12
137 Written evidence from Neena Gill MEP (FS0013)
138 Written evidence from the Loan Market Association (FRS0002)

from the EEA, and we need to think about how we can authorise those institutions."[139] Lowri Khan, of HM Treasury, said: "A certain amount could be done by allowing inbound firms to continue to service existing contracts. A range of different approaches could be taken. We are working through them to see which would best fit the circumstances and our objectives."[140]

76. It is noteworthy that the Bank of England has recently consulted on proposals that would allow EU wholesale banks and insurers to be re-authorised as branches within the UK and so not be required to establish subsidiaries.[141] The FCA also stated that it anticipates that "firms will be able to continue to benefit from passporting between the UK and EEA after the point of exit and during the implementation period".[142] The Chancellor of the Exchequer confirmed in a written statement that: "As requested by the Bank and the FCA, the Government will, if necessary, bring forward legislation … which will enable EEA firms and funds operating in the UK to obtain a 'temporary permission' to continue their activities in the UK for a limited period after withdrawal."[143] We are encouraged by the Bank's initiative, and the Chancellor's statement.

Conclusions and recommendations

77. **A crucial element of the EU (Withdrawal) Bill process will lie in the resolution of 'inoperables': references to, for example, EU bodies that will no longer have jurisdiction after Brexit. Translating the *acquis* will also require dealing with the agreements the EU has with third countries. These cover areas such as equivalence rulings with non-EU members (for example the agreement with the US under EMIR, which allows EU clearing members to use US CCPs). The UK will need to decide how to incorporate these agreements. UK regulators have also begun to make statements regarding their proposed treatment of EU businesses within the UK. The clarity that these decisions will ultimately provide is very much to be welcomed. However, insofar as there is a risk to UK financial stability in granting access to third country firms, a new domestic permissions regime must be carefully managed.**

Future parliamentary scrutiny

78. It is clear from the preceding paragraphs that Brexit will entail a substantial transfer of powers from EU institutions to domestic regulators. This has implications for the terrain of parliamentary scrutiny. That scrutiny is currently configured to reflect the UK's membership of the EU: the House of Lords EU Financial Affairs Sub-Committee scrutinises legislation emerging from the EU in economic governance and financial services, as does the House of Commons European Scrutiny Committee. Withdrawal from the EU will necessarily change this model. In the context of financial services, once the end state has been reached, the complexity of the probable

139 Q 65

140 Q 123

141 Bank of England, Press Release: *The Bank of England's approach to the authorisation and supervision of international banks, insurers and central counterparties* (20 December 2017): https://www.bankofengland.co.uk/news/2017/december/approach-to-authorisation-and-supervision-of-international-banks-insurers-central-counterparties [accessed 12 January 2018]

142 Financial Conduct Authority, Press Release: *FCA statement on EU withdrawal* (20 December 2017): https://www.fca.org.uk/news/statements/fca-statement-eu-withdrawal [accessed 12 January 2018]

143 HC Deb, 20 December 2017, col 57WS

legislative process (involving both primary and secondary legislation and regulatory technical standards), coupled with the continued need to make policy in light of international standards and, in the event of a market access agreement being reached, EU law, will place considerable demands on the parliamentary scrutiny process.

79. Professor Niamh Moloney accordingly asked: "Where will the Financial Conduct Authority, the Bank of England and the Prudential Regulation Authority emerge at the end of this process as regards their regulatory powers to finesse and amend secondary legislation in a way that is nimble and gives the EU comfort?"[144] The Financial Services Consumer Panel argued that "the way power, responsibility and accountability is distributed between these institutions will have a profound impact on all users of financial services. It is vital this impact is considered in the design of the post-exit framework."[145]

80. Our witnesses certainly did not want the *acquis* to be transferred wholesale into primary legislation—as the Building Societies Association commented, it would be unworkable to require primary legislation every time regulations needed to be modified: "This cannot be a sensible outcome for banking regulation."[146] A similar objection may be made to the use of delegated legislation: as Stephen Jones told us, if every piece of regulation needs to go through the Withdrawal Bill process, "you are not going to be sleeping very much for the next 18 months".[147] This would therefore suggest that the majority of the current rulebook should be adopted by the UK's regulators. A balance will therefore need to be struck between parliamentary scrutiny and flexibility.

81. This was identified as a challenge by several industry witnesses. PwC stated:

> "Brexit has the potential to increase the powers and centralisation of the PRA and FCA significantly, as they are granted further direct and indirect supervisory and rule making powers post-Brexit … These developments further emphasise the need for accountability and scrutiny of the regulatory bodies by Parliament (through existing mechanisms) and openness and dialogue with industry and other stakeholders on regulatory decisions."[148]

Clifford Chance agreed that incorporating rules into existing handbooks "raises the issue of the extent to which parliamentary scrutiny should be imposed over such rulemaking and, in particular, whether Parliament should be involved in subsequent amendments of such rules".[149] Dr Kay Swinburne MEP was clear that "If Parliament here has no oversight of the agencies' rule-making and no ability to call them back in any way or to tell them that they are not in line with the original political intent, we are in a very difficult position, where you give a huge amount of authority and discretion to unelected, unaccountable entities".[150]

82. The regulators recognised this challenge, which Andrew Bailey described as "a big issue for the role of Parliament", adding that "it would make sense

144 Q 6
145 Written evidence from the Financial Services Consumer Panel (FRS0024)
146 Written evidence from the Building Societies Association (FRS0010)
147 Q 36
148 Written evidence from PwC (FRS0019)
149 Written evidence from Clifford Chance (FRS0039)
150 Q 147

from the point of view of our accountability for there to be the power for Parliament to scrutinise things that we do in the future. I would not object; in fact, I would welcome it in some ways." At the same time, he was "hesitant about making it the norm, simply because of the sheer volume of activity across the board, not just from us but in every other walk of public policy implementation". Nevertheless, Mr Bailey stressed that "it is for you to decide what the role of Parliament is and not for us".[151] Julian Adams of Prudential concurred: "Clearly, it is for Parliament to decide how much is done by Parliament."[152]

83. The transfer of powers to regulators also raises the issue of accountability to Government. Mr Adams told us that accountability would be due not only to Parliament, but also "we would want to introduce another intervention point, which we argue would be the Treasury".[153] PwC agreed that interaction between government, the industry and regulators would need to be institutionalised in future: "There should be effective collaboration between different Government departments, the industry and regulators in order to agree on priorities and actions." They argued that "A joint body will need to be instituted to meet regularly."[154]

84. A further issue is the extent to which Government and the regulators should consult with industry. Andrew Bailey commented: "We consult when we are implementing European legislation, although of course it is a very constrained form of consultation because we cannot change the underlying rules in that situation. We are under a responsibility to produce a cost-benefit analysis, which we do, for the proposals we make."[155] UK Finance noted: "There will be an important role for the regulators such as the PRA and FCA in both helping to define the Government's aims and in translating the Government's approach into clear guidelines for business. Close consultation with the banking and financial sector will be important to assist in the implementation of the task of transposition and reduce the risk of accidental errors."[156] The ABI also encouraged the Government "to consult extensively, and to draw on the experience of as many stakeholders as possible", in particular before making delegated legislation.[157]

85. In considering how to carry out scrutiny in future, Parliament may wish to take account of the EU's legislative scrutiny process. The Committee's previous inquiry, *The post-crisis EU financial regulatory framework: do the pieces fit?*,[158] heard a large amount of evidence from witnesses on the involvement of the European Parliament. Views on the substantive contribution made by MEPs were mixed: some witnesses (including those from industry) highlighted the sheer volume of work performed by MEPs during the crisis, amending some 30–40% of legislative texts, while others were of the view that some of these amendments were misguided.

86. In the present inquiry, Dr Kay Swinburne MEP praised the EU's scrutiny processes, noting that it "set up a specific system where the Parliament and

151 Q 99
152 Q 85
153 Q 81
154 Written evidence from PwC (FRS0019)
155 Q 99
156 Written evidence from UK Finance (FRS0044)
157 Written evidence from ABI (FRS0008)
158 European Union Committee, *The post-crisis EU financial regulatory framework: do the pieces fit?* (5th Report, Session 2014–15, HL 103) pp 30–32

the Council have oversight of every rule that is made and the right to reject a rule if it is not in line with the political intent". In particular, Dr Swinburne emphasised that the EU's system had been instituted in response to concerns over the scrutiny process in place in the US, in which "the agencies are much more independent. Once they have the primary legislation handed to them, as a very large dossier, they effectively have little oversight of what goes on at the rule-making stage". She argued that the EU had decided that this "was not a suitable system for modern-day financial services, because it gave too much interpretive value to the regulators themselves, with no scrutiny or accountability".[159]

87. Dr Swinburne also noted the huge difference between the resources devoted to scrutiny in the European Parliament, and those currently available in the UK Parliament:

> "The system in the UK needs to be reviewed. As a member of a committee in the European Parliament … I have resources that allow me to do impact assessments if we feel that the Commission's impact assessments are not good enough. We have a policy unit that supports our work … We have external consultancies on our books that we can call upon to do external studies for us at any point, and we can call hearings and workshops on any topic that the committee decides to investigate. We have a very comprehensive set of tools at our disposal, with significant financial resources to make sure that, as non-experts, we have experts advising us at every stage."[160]

88. Nonetheless, the current process of agreeing and scrutinising EU legislation is not without its critics, and the Investment and Life Assurance Group (ILAG) described it as "unwieldy and opaque: not all stages are open to public consultation". They also highlighted the burden that engaging with the EU regulatory process placed upon industry: "Whilst the Level 1 legislation usually has a two-year implementation period, in practice most of this time is taken up by the EU bodies developing Level 2 material, leaving firms uncertain as to the detailed requirements until very close to the date by which they are required to comply." They argued that lack of accountability and transparency "puts unnecessary strain on resources, and risks failure to implement on time".[161] The UK's future legislative and scrutiny processes will need to be carefully designed to ensure the right balance is struck.

Conclusions and recommendations

89. **The Government will need to adopt a nuanced approach towards the translation of EU regulation into domestic law. In future some rules will need to be enshrined in statute, which could be effected using powers contained in the European Union (Withdrawal) Bill. However, it may be more appropriate, where it is important that rules be flexible and dynamic, or where they concern more technical areas, for regulators to issue guidance and set standards. The Government should develop an appropriate architecture for the future domestic regulation of financial services.**

159 Q 147
160 Q 147
161 Written evidence from ILAG (FRS0014)

90. **Any future regulatory regime will probably result in a significant increase in the powers of domestic regulators to determine rules and provide non-statutory, but binding, guidance. It is vital that Brexit, in transferring powers to domestic regulators, should not result in an unintended deficit in democratic scrutiny and accountability.**

91. **The EU's multi-layered approach to financial regulation is underpinned by detailed and resource-intensive scrutiny by the European Parliament. Assuming that domestic regulators will gain powers as a result of Brexit, the Westminster Parliament will need to increase commensurately the resources available to support a similar level of scrutiny. This is particularly the case with regard to the regulation of financial services, where powers transferred from the EU to UK regulators will require ongoing specialist scrutiny if the UK is to replicate the level of oversight that the European Parliament has to date provided.**

92. **We note that this issue concerns both Houses; we also note the forthcoming review of the Committee structure of the House of Lords, which is being conducted by the House of Lords Liaison Committee. In light of these factors, we do not seek to make specific recommendations on future parliamentary scrutiny. It is clear, however, that financial services will require increased scrutiny and resources in relation to domestic, EU and international level regulatory standards, and that the burden will necessarily fall upon Parliament. We look forward to the House of Lords Liaison Committee addressing this issue in the course of its review.**

CHAPTER 4: POSSIBILITIES FOR A TRANSITION PERIOD

The Committee's letter to the Chancellor of the Exchequer on the need for a transition

93. From an early stage of the inquiry, witnesses emphasised how vital a transition period, before current relationships change, would prove—for both financial services providers, and for the businesses relying on them, across the whole of the EU. Catherine McGuinness, Policy Chairman of the City of London Corporation, told us that the most critical requirement was "knowing now—and I mean now, as soon as possible, such that there will be further time to work this through".[162]

94. On 8 November 2017 we therefore wrote to the Chancellor of the Exchequer (see Appendix 4) to highlight the pressing need for the UK Government to seek an agreement on a 'standstill' transition period in the negotiations.[163] The urgency of this issue was reflected in our decision to issue the letter at the mid-point of the inquiry, rather than waiting for this report. The letter echoed the Chancellor's own words in describing such a period as a 'wasting asset': if it were to be agreed too late, it would have little impact on the financial services sector's contingency planning. The letter also outlined concerns regarding contractual continuity and the potential legal form of such a transition agreement.

95. The Chancellor replied on 2 December 2017. He stated that the Government "agreed with the Committee on the importance of minimising any risks of disruption as the UK withdraws from the EU, and maintaining the ability of the financial services industry to continue the orderly service of cross-border clients".[164] He pointed to the comments of the Financial Policy Committee on cross-border contractual continuity contained in its November *Financial Stability Report*, particularly with regard to risks associated with over-the-counter (OTC) derivatives and insurance contracts.[165] The Chancellor made clear that the Government was considering all risks associated with contractual continuity, and that "an integral part of delivering our withdrawal will be the negotiation of a time-limited implementation period, to provide certainty and avoid a cliff-edge for business and individuals during the adjustment from the current structures of membership to the new relationship".[166]

162 Q 27

163 Letter to the Rt Hon Philip Hammond MP, Chancellor of the Exchequer, from Baroness Falkner of Margravine Chairman, EU Financial Affairs Sub-Committee on 'financial regulation and supervision following Brexit' (8 November 2017): http://www.parliament.uk/documents/lords-committees/eu-financial-affairs-subcommittee/financial-regulation-and-supervision/Transition-letter-to-Chancellor.pdf [accessed 18 December 2017]

164 Letter to Baroness Falkner of Margravine Chairman, EU Financial Affairs Sub-Committee from the Rt Hon Philip Hammond MP, Chancellor of the Exchequer on 'financial regulation and supervision following Brexit' 2 December 2017: https://www.parliament.uk/documents/lords-committees/eu-financial-affairs-subcommittee/financial-regulation-and-supervision/Transition-letter-from-Chancellor-04.12.17.pdf [accessed 12 January 2018]

165 Bank of England, *Financial Stability Report* (November 2017): https://www.bankofengland.co.uk/financial-stability-report/2017/november-2017 [accessed 19 January 2018]

166 Letter to Baroness Falkner of Margravine Chairman, EU Financial Affairs Sub-Committee from the Rt Hon Philip Hammond MP, Chancellor of the Exchequer, on 'financial regulation and supervision following Brexit' (2 December 2017): https://www.parliament.uk/documents/lords-committees/eu-financial-affairs-subcommittee/financial-regulation-and-supervision/Transition-letter-from-Chancellor-04.12.17.pdf [accessed 12 January 2018]

The need for a transition and implementation period

96. Both industry and regulators made a convincing case for the financial stability benefits of a transition period. However, the term 'transition period' disguises a number of different possible meanings. Stephen Jones, Chief Executive of UK Finance, told us: "One person's transition is someone else's standstill is someone else's implementation, and one of the biggest problems in this debate is language."[167] Andrew Bailey stated that transition was "separate" from "an implementation agreement. The reason why it is understandable that they get conflated is that they may well overlap in time, but they are conceptually slightly different."[168] Miles Celic, Chief Executive of TheCityUK, defined two distinct phases: "First, there is a bridging period between the end of the Article 50 process and the start of the new relationship, should that be required … and then an adaptation period."[169] The European Union Committee's report, *Brexit: deal or no deal*, published in December 2017, endorsed this analysis, concluding that there were "two aspects of transition: a 'standstill period' … and an implementation or adaptation period".[170]

97. The Government's position was set out in Prime Minister Theresa May's speech in Florence on 22 September 2017, in which she described a period of 'implementation', to be agreed under Article 50. This would take place "after the UK leaves the EU", and would provide that "access to one another's markets should continue on current terms", ensuring that businesses "only have to plan for one set of changes in the relationship between the UK and the EU". This period, the Prime Minister said, should be "strictly time-limited", its length determined "by how long it will take to prepare and implement the new processes and new systems that will underpin that future partnership". This, she believed, would entail a period of approximately two years.[171]

98. Stephen Jones summarised the Government's ask as "an implementation period that would take effect in March 2019, there having been reached a detailed agreement in trade and services before then".[172] Such an implementation period would indeed be welcome, as it would give industry time to adapt to the new rules in an orderly fashion, but implementation, as Catherine McGuiness told us, only makes sense if parties know what the future arrangement will look like.[173] Miles Celic commented that "the nature of FTAs is that you go through and agree them, then move to an adaptation period where it is effectively bedded in".[174]

99. John McFarlane explained the view of Barclays: "Transitioning is most valuable if it is to somewhere worthwhile at the end. Transitioning to nowhere

167 Q 37
168 Q 100
169 Oral evidence taken before the European Union Committee, 24 October 2017 (Session 2017–19), QQ 22 and 28 and written evidence from TheCityUK (DND0015) para 26
170 European Union Committee, *Brexit: deal or no deal* (7th Report, Session 2017–19, HL Paper 46) para 129
171 Rt Hon Theresa May MP, speech on 'a new era of cooperation and partnership between the UK and the EU' (22 September 2017): https://www.gov.uk/government/speeches/pms-florence-speech-a-new-era-of-cooperation-and-partnership-between-the-uk-and-the-eu [accessed 12 January 2018]
172 Q 37
173 Q 27
174 Oral evidence taken before the European Union Committee, 24 October 2017 (Session 2017–19), Q 28

does not have the same value."[175] This concern clearly resonated across the industry, as Charlotte Crosswell of Innovate Finance told us: "There would be huge value in a transition period, because FinTech firms would know what they were trying to move towards."[176] Sir Jon Cunliffe told us that the destination of transition was also critical for the regulators, arguing that it was crucial from a financial stability perspective that "firms have the ability to make a transition to wherever they need to go, in good time and in an orderly way"; he quoted the Chancellor's perspective that "you do not want firms to make changes twice … so they need to have some idea of the end point they are moving to".[177]

100. Witnesses were, however, dubious that a final agreement, which adequately covered services, could be struck prior to March 2019. As John McFarlane said: "I do not think that is very likely, so we will have to work in this uncertain period not knowing where we will end up."[178] Miles Celic noted that the time available to reach such a "full, comprehensive free-trade agreement"was in fact less than 12 months, because "clearly this will need to go to individual parliaments and so forth for ratification on the European side".[179] He described the Government's approach as "ambitious", and commented that the Comprehensive Economic and Trade Agreement (CETA) between Canada and the EU took seven years to agree. Precedent, as the European Union Committee noted in its report on *Brexit: deal or no deal*, suggests that a 'standstill' period will probably be needed, "to buy time to finalise an agreement on the future relationship".[180]

101. It is unclear how the Commission's position aligns with a two-stage transition period. The Commission's negotiating guidelines of 29 April 2017 specify that "to the extent necessary and legally possible, the negotiations may seek to determine transitional arrangements … to provide for bridges towards the foreseeable framework for the future relationship in the light of the progress made".[181] The Commission has since added that a transition period should continue the current *acquis* in its current form, and last until the end of 2020 to dovetail with the period of the current multiannual financial framework.[182] The accompanying Commission proposals make clear that during the transition period "the competences of the Union institutions (in particular the full jurisdiction of the Court of Justice of the European Union)" should be honoured.[183] This sounds like a standstill, not an implementation or

175 Q 111
176 Q 91
177 Q 65
178 Q 111
179 Oral evidence taken before the European Union Committee, 24 October 2017 (Session 2017–19), Q 22
180 European Union Committee, *Brexit: deal or no deal* (7th Report, Session 2017–19, HL Paper 46) para 129
181 European Council, 'Guidelines following the United Kingdom's notification under Article 50 TEU' 29 April 2017: https://www.consilium.europa.eu/media/21763/29-euco-art50-guidelinesen.pdf [accessed 18 January 2018]
182 Alex Barker, Jim Brunsden and Henry Mance, '"Brexit transition must end in December 2020", says Barnier', *Financial Times* (20 December 2017): https://www.ft.com/content/836e5878-e57d-11e7-97e2-916d4fbac0da [accessed 18 January 2018]. See also European Union Committee, *Brexit and the EU Budget* (15th Report, Session 2016–17, HL Paper 125).
183 Annex to the recommendation for a Council Decision supplementing the Council Decision of 22 May 2017 authorising the opening of negotiations with the United Kingdom of Great Britain and Northern Ireland for an agreement setting out the arrangements for its withdrawal from the European Union, COM(2017) 830 final

adaptation period, and there is no guarantee that the fixed time period will align with the agreement of a future relationship.

Conclusions and recommendations

102. **Transition should in the first instance provide a standstill extension of the current conditions of market access: this appears to be envisaged by both the Commission and the Government. To be useful, however, any period of transition needs to form part of a three-stage process. First, a standstill period, allowing time for the two sides to agree the terms of their future relationship; then, once that relationship (the ultimate destination) is known, a period of adaptation; and, finally, the seamless commencement of trade under the terms of the new relationship. Absent all these elements of transition, financial services firms will be forced to activate their worst-case scenario contingency plans, with stark implications for the continued provision of services and for financial stability.**

Making and averting contingency plans in financial services

103. The financial services industry has already made contingency plans for the 'worst-case' scenario that no agreement will be in place on the date of Brexit, 29 March 2019. As Sally Dewar of JP Morgan said: "When we think about Brexit, we do not assume any negotiated position. For us, it is a hard Brexit position."[184] EU agencies have published guidance to business outlining that the UK will become a third country (we note that no guidance was issued to the financial services industry).[185] For the industry's contingency plans not to be activated, a transition period must be announced imminently to address these concerns, or it will be too late. Simon Gleeson, Partner at Clifford Chance, put it bluntly: "If business thinks that it is heading for no deal and no transition, it will be under enormous pressure to move to Europe, and will do so. If at the end of the process we discover that we had a transition after all, that transition will be completely useless."[186]

104. Contingency planning for a 'no deal' scenario is being supported by the PRA, which has, as Sam Woods explained, "asked firms to show us what they would do in order to preserve the safety and soundness of their business in the event that, at the end of March 2019, there is no successor to passporting as it currently exists between the UK and the EU-27, and there is no transition period".[187] Sally Dewar explained that the PRA asked firms to consider "three scenarios: worst case, best case and a middle case. The PRA focus was on the worst-case scenario and the contingency around that."[188] John McFarlane, Chairman of Barclays, painted a similar picture.[189] On the basis of these contingency plans, Sam Woods told us that he expected "around 2% of UK bank and insurance jobs," to move to the EU on day one, with more to follow after that depending on the form of the agreement that is reached between the UK and EU.[190]

184 Q 83
185 Jim Pickard and Alex Barker, 'David Davis attacks EU's "damaging" no-deal Brexit planning', *Financial Times* (8 January 2018): https://www.ft.com/content/7306b972-f49a-11e7-88f7-5465a6ce1a00 [accessed 18 January 2018]
186 Q 13
187 Q 64
188 Q 83
189 Q 109
190 Q 64

105. A significant part of firms' relocation plans concerns the need to set up and authorise businesses within the EU-27, in the event that there is a diminution or cessation of access by UK firms to the EU's markets. This requires firms to secure licensing approvals, which in turn necessitates a long lead-in time. Barclays told us: "Significant execution actions in respect of Barclays' relocation plan, which it will be very difficult and costly to reverse, will begin towards the end of Q4 2017 in order to dovetail with necessary licensing approvals."[191] The London Metal exchange agreed that it would take 18–24 months to acquire the necessary licences in order to continue servicing clients in EU countries;[192] PwC also suggested that "getting a banking licence can take up to 18 months".[193] In addition to obtaining licences for new business, moves may involve setting up subsidiaries from scratch: Lloyd's, the insurance market, is already establishing a subsidiary insurance company within the EU in order to continue to write EU business.[194]

106. Thus businesses are having to move to stand still. Sally Dewar stated that their goal was "to ensure uninterrupted service to our clients. When we think about hard Brexit, the focus is on how we make sure that we continue to serve those clients in the same way as today from 1 April 2019."[195] Sir Jon Cunliffe agreed: "Firms are doing what you would expect them to do. They are saying, 'Until I know what happens, I will assume no European authorisations other than WTO, and no transition', and that is necessary for the management of stability risk as a whole."[196] We heard evidence that the industry is well prepared, but cannot afford to wait until the final shape of an agreement is visible before taking irrevocable decisions. Sally Dewar emphasised that JP Morgan had "a very well-established transition plan to make sure that we are ready in time, but we are already in execution mode".[197]

Timing and form of an agreement

107. The Minister, Stephen Barclay MP, stated that "we are all acutely aware that timing is a critical factor in transition for firms' contingency plans. Early agreement on transition is clearly desirable."[198] Mr Gleeson said in October that the deadline would be Christmas 2017;[199] Jonathan Herbst and Mark Hoban both told us "the sooner the better".[200] Sam Woods commented: "If we get to around the new year and there has not been a clear political announcement from both sides on a transition, for purely operational reasons we will need to get going on all that work."[201] Andrew Bailey agreed that "it is necessary to have a transition period to allow us time to deal with those risks. That is the thing that needs to be sorted out PDQ."[202] On the other hand, the Secretary of State, the Rt Hon David Davis MP, stated on 2 January 2018 that agreement on a transition "by March [2018] is doable".[203]

191 Written evidence from Barclays (FRS0040)
192 Written evidence from the London Metal Exchange (FRS0048)
193 Written evidence from PwC (FRS0019)
194 Written evidence from Lloyd's and the Lloyd's Market Association (FRS0028)
195 Q 84
196 Q 65
197 Q 84
198 Q 117
199 Q 18
200 Q 18 (Jonathan Herbst), Q 27 (Mark Hoban)
201 Q 65
202 Q 100
203 David Davis, 'How we will deliver the best Brexit in 2018', *The Daily Telegraph* (1 January 2018): http://www.telegraph.co.uk/news/2018/01/01/will-deliver-best-brexit-2018 [accessed 16 January 2018]

108. Stephen Jones was emphatic that UK Finance's members' plans would be enacted shortly: "The latest date by which most of our mutual members tell us that they can avoid exercising their contingency plans is the end of this year [2017], or possibly Q1 of next year."[204] UK Finance's members would take promises to deliver a future agreement by March 2019 "with a certain pinch of salt", adding that if businesses had to wait until March 2019 for "confirmation that there is that 'implementation period' and for confirmation as to what that implementation period is actually implementing",[205] they would invoke their contingency plans.

109. The legal form of a transition period is an open question. The CBI stressed that the UK Government and EU-27 should "commit to binding transitional arrangements as soon as possible to manage uncertainty for businesses and bolster confidence".[206] But the meaning of 'binding' is by no means clear. Clifford Chance interpreted an 'agreement' as no more than "a common announcement by the EU and the UK of an understanding on this issue. This is because a transitional agreement becomes of limited value if its announcement is delayed, and it will not be possible to implement a formal agreement in the time available."[207] However, Miles Celic of TheCityUK was emphatic that a political declaration would "not be ample—nor, for many companies, sufficient", and called instead for "a legally binding agreement between the UK and the EU-27 that there will be a transitional period".[208] He suggested this could be achieved through a number of means, including lodging a Memorandum of Understanding with the UN.

110. Mark Hoban summarised the issue thus: "An agreement in principle from the EU-27 that there will be a transition period would be very helpful. There is a continuum from a planned statement in a communiqué to something that is legally watertight and, frankly, for the industry, the closer we are to legally watertight, the better."[209] Andrew Bailey concurred: "We need something that is legally binding, in the sense that it can be applied."[210] He suggested that this could be written into European Council conclusions. Sir Jon Cunliffe was more cautious: "I do not see any way that the European Council could make a legally binding commitment until it either has a treaty between the UK as a non-EU member and the EU, or some other legal means."[211] He felt that a political statement would be more feasible: "If firms know that this issue is going to be addressed, how it is going to be addressed, and there is a legal vehicle to take it forward, then my view is that it would give them much of the certainty they need."[212]

111. The European Union Committee's recent report, *Brexit: deal or no deal*, focused on the logic of the EU's legal framework: "Article 50 provides only for a withdrawal agreement—any final agreement on the future UK-EU relationship will require a separate legal base (most likely to be Article 218 TFEU), and the European Council guidelines confirm that such an agreement can only be concluded once the UK is no longer a Member State.

204 Q 37
205 Q 37
206 Written evidence from the CBI (FRS0025)
207 Written evidence from Clifford Chance (FRS0039)
208 Oral evidence taken before the European Union Committee, 24 October 2017 (Session 2017–19), Q 31
209 Q 27
210 Q 100
211 Q 65
212 Q 65

Prior to 29 March 2019, the most that can be achieved is a political agreement on that future relationship."[213]

Contractual continuity

112. Many of our witnesses pointed to contractual continuity as a concern allied with the need for a transition period. The issue is of particular concern to insurers. In the words of Lloyd's, "Without a transitional arrangement, 29 March 2019 will see Lloyd's underwriters immediately losing their authorisation to carry on business in EEA countries on a services or an establishment basis."[214] PwC cautioned that without an agreement, insurers would "risk breaching regulatory requirements, as well as potentially committing a criminal offence for carrying on regulated business without required authorisations".[215] Zurich, the Swiss-based insurance group, argued for "a permanent solution to ensure service continuation until their termination",[216] while Simon Lewis, Chief Executive of AFME, told us that "contracts should be grandfathered [treated for their duration under existing terms] to provide certainty to all parties".[217]

113. However, the need for contractual continuity in insurance, while it may coincide in large part with any transitional arrangements, also has much longer-term implications. The Financial Services Consumer Panel noted that "hundreds of thousands of existing insurance contracts have terms covering decades".[218] Lloyd's also argued that "this is not an issue that can be resolved purely through a transitional arrangement, which may only be in place for a short period. It needs to be considered as a separate issue."[219] Zurich agreed that transitional measures were "unlikely to resolve the problem of servicing contracts written under passporting".[220] We therefore anticipate that issues of contractual continuity will be dealt with on a permanent basis, either as part of a separate treaty, or through the Article 50 withdrawal agreement.[221]

114. In sectors other than insurance, issues of contractual continuity (including the servicing of derivatives contracts and cross-border loans) are likely to be shorter term, with more scope to be resolved within the terms of transition. Simon Puleston Jones, Head of Europe at the Futures Industry Association (FIA), told us that as far as the issues for derivatives contracts are concerned, "We tend to talk about grandfathering not in a contractual sense but in a regulatory sense … From a regulatory perspective, the grandfathering would end at the end of the transition period. The extent to which grandfathering is needed beyond that for contractual reasons is something that still requires further analysis at this stage."[222]

115. Sam Woods identified three options for resolving the problem of contractual continuity. His preferred solution would be to include contractual continuity "in the withdrawal agreement, or a separations issue agreement of some

213 European Union Committee, *Brexit: deal or no deal* (7th Report, Session 2017–19, HL Paper 46) para 111
214 Written evidence from Lloyd's and the Lloyd's Market Association (FRS0028)
215 Written evidence from PwC (FRS0019)
216 Written evidence from Zurich Insurance (FRS0042)
217 Q 31
218 Written evidence from the Financial Services Consumer Panel (FRS0024)
219 Written evidence from Lloyd's and the Lloyd's Market Association (FRS0028)
220 Written evidence from Zurich Insurance (FRS0042)
221 European Union Committee, *Brexit: deal or no deal* (7th Report, Session 2017–19, HL Paper 46) para 87
222 Q 54

kind—a bilateral agreement to fix these things in a symmetrical way on both sides". There was precedent for this approach in the introduction of the euro, which superseded contracts written in the legacy currencies: "That would be by far the best fix; that would give certainty, and would effectively deal with the issue."[223] Andrew Bailey concurred: "You could deal with it in the Article 50 agreement itself. In many ways, that would be the simplest thing to do."[224]

116. Mr Woods identified two less effective options. One was for "the UK and the EU-27 … either in a loose agreement or entirely separately but informally coordinated, [to] take unilateral actions to deal with that problem". This, he suggested, would be "messy". The least desirable outcome, which he said was "very unlikely to be satisfactorily effective" was "self-solving by firms", where they move contracts: "They can set up a thing called a *societas Europaea* and move that across a border."[225] The Investment and Life Assurance Group (ILAG) further explained that contractual consolidation was, in the normal order of things, "delivered through a Transfer of Engagements under Part VII of the Financial Services and Markets Act 2000". They continued: "This process works well, albeit with the commitment of time and money, and requires the UK regulators to notify any relevant EU regulator where there is expected to be an affected policyholder in that territory. There is a period of three-months for the relevant EU regulator to raise objections to the proposed transfer; no response is regarded as consent."[226]

117. An alternative, according to Mr Woods, was for firms to get their clients to agree to re-issue existing contracts through new bodies (known as re-papering), but he did not believe "that all these contracts with all customers can be re-papered in the timeframe that we are talking about".[227] Andrew Bailey agreed: "The problem with leaving firms to sort it out is that it is extremely disruptive and there is not enough time to do it. It means novation of contracts, for instance. It involves court processes, and there just is not enough time to deal with the volume."[228] The record of the FPC's meetings on 22 and 27 November 2017, published 5 December, subsequently revealed that "the Bank had written to the High Court to alert them to the potential for increased applications".[229]

118. There is, finally, an outstanding issue concerning the status of contracts entered into during any transition period. Professor Eilís Ferran told us that, while it seemed straightforward to "preserve legal rights that have already been acquired, and not disrupt them", allowing certainty for new contracts entered into during a transition period "gets you into a much more open-ended and rather difficult area".[230] Jonathan Herbst identified two distinct issues: the first was, "Can you lawfully continue to provide business cross-border?" The second was, "Are pre-existing contracts still binding and valid? It does not automatically follow from a lack of the first that the second

223 Q 66
224 Q 101
225 Q 66
226 Written evidence from ILAG (FRS0014)
227 Q 66
228 Q 101
229 Bank of England, *Record of the Financial Policy Committee Meetings held on 22 and 27 November 2017* (5 December 2017): https://www.bankofengland.co.uk/record/2017/financial-policy-committee-november-2017 [accessed 16 January 2018]
230 Q 7

is the case."[231] This would also need to be written into any agreement on withdrawal and transition in order to resolve uncertainty.

Conclusions and recommendations

119. **We welcome the announcement by the European Council that the first priority for negotiations in 2018 will be agreement on transition. Such an agreement needs to be announced soon for it to prevent the enactment of the financial services industry's contingency plans, with the disruption and uncertainty that would cause for counterparties in both the UK and the EU-27.**

120. **We note the views of those in the financial services sector who seek a legally binding transition agreement in Q1 2018. Whether or not this is feasible, any such agreement will need to be at least politically binding if it is to provide reassurance to firms that there will be no cliff-edge in 2019. Due to the central position of the UK's financial services sector within the EU's financial services industry, and the number of EU-27 clients that rely on accessing this market, it is in the interests of both the UK and the EU that such an agreement is in place, in order to prevent large-scale risks to financial stability.**

121. **It will be essential, either alongside or as part of a transition agreement, to provide clarity on issues of contractual continuity. Insurance contracts will need to be 'grandfathered'—treated according to current terms—for their duration. It may be possible for other contractual issues, such as the servicing of derivatives contracts, to be provided for within the time-limited confines of a transition period, but such a period cannot be expected to solve all issues. It is imperative therefore that continuity of contracts is treated and resolved comprehensively.**

231 Q 13

CHAPTER 5: ALIGNMENT AND MARKET ACCESS

Developments in the Government's negotiating position

122. Our December 2016 report, *Brexit: financial services*,[232] analysed the EU's passporting and equivalence regimes, alongside the models for market access then under consideration. In particular, it assessed and compared the features of the EEA ('Norway') model, the customs union, a free trade agreement, EFTA membership and bilateral agreements (the 'Swiss model'), and trade on WTO terms (the 'no deal' option). While this report does not seek to cover the same ground, some aspects of the debate have now moved on, making it appropriate to reconsider them.

123. The Prime Minister stated in her Lancaster House speech in January 2017 that the UK would be leaving the Single Market and therefore appeared to rule out EEA and EFTA membership.[233] The Secretary of State, the Rt Hon David Davis MP, restated this policy on 7 September 2017, when he told the House of Commons that "The simple truth is that membership of the European Free Trade Association, for example, which would be one way to retain EEA membership, would … keep us within the *acquis*, and it would keep us within the requirements of free movement, albeit with some limitations, but none of those have worked so far. In many ways, it is the worst of all outcomes."[234]

124. Instead, as the City Minister told us: "The Prime Minister has set out the Government's intention for a free trade agreement on goods and services."[235] In other words, of the models for the future relationship analysed in our December 2016 report, all but two—a free trade agreement, or the 'no deal' option—have been ruled out by the Government.

125. This section therefore outlines the current state of play with respect to regulating future market access, on the basis of the Government's stated intentions.

Equivalence and its limitations

126. The Commission's existing arrangement for the recognition of third-country financial services is by means of a so-called 'equivalence' regime. Our December 2016 report covered in some detail the origins and shortcomings of the equivalence regime. In brief, equivalence provides a means for the EU to recognise third-country regulatory regimes in particular sectors, in order to reduce overlaps in regulatory compliance for the firms concerned (and for their supervisors); reduce the burdens of the prudential regime on EU firms with respect to their exposures to third countries; and provide EU firms and investors with a wider range of services, instruments and investment choices originating from third countries that can satisfy regulatory requirements in the EU.[236]

232 European Union Committee, [Brexit: financial services](#) (9th Report, Session 2016–17, HL Paper 81).
233 Rt Hon Theresa May MP, speech on 'The Government's negotiating objectives for exiting the EU' (17 January 2017): https://www.gov.uk/government/speeches/the-governments-negotiating-objectives-for-exiting-the-eu-pm-speech [accessed 18 January 2018]
234 HC Deb 7 September 2017, col 286
235 Q 117
236 European Parliament, *Third-country equivalence in EU Banking legislation* (12 July 2017): http://www.europarl.europa.eu/RegData/etudes/BRIE/2016/587369/IPOL_BRI(2016)587369_EN.pdf [accessed 12 January 2018]

127. The EU does not regard equivalence as a means primarily of providing market access: a Commission Staff Working Document, published on 27 February 2017, stressed that "equivalence decisions in a few areas may enhance the possibilities of doing business in the EU (e.g. investment firms under MiFID II), but the equivalence as such serves primarily prudential regulatory purposes and is a tool to reduce overlaps in compliance in the interest of EU markets". As such, "Equivalence is not a vehicle for liberalising international trade in financial services, but a key instrument to effectively manage cross-border activity … with third-country jurisdictions that adhere to, implement and enforce rigorously the same high standards of prudential rules as the EU."[237]

128. In contrast to the current passporting regime for EU-based firms, equivalence does not offer comprehensive cross-border access to the EU's markets. As Lloyd's concluded, "In general, [equivalence] provisions do not provide market access to third country undertakings."[238] This is in part, as Simon Gleeson told us, because "Europe does not have an equivalence doctrine at the moment. It has a fragmented set of equivalence provisions put into different directives for different purposes."[239] Sir Jon Cunliffe agreed, adding that "for the main banking services, there is no equivalence. There is only the passport."[240]

129. As of 31 December 2016, 37 countries were the subject of equivalence determinations across the 13 pieces of legislation that provide for third country regimes. These are summarised in Table 1.

Table 1: Third country equivalence provisions

Name of overarching regulation	Type of equivalence determination	Number of countries with determination
Prospectus (Regulation and Directive)	Equivalence of prospectuses	0
	Third country GAAP (Generally Accepted Accounting Principles) with IFRS	5
Transparency Directive	Third country GAAP with IFRS	5
	Third country GAAP with IFRS transition	1
	General transparency requirements	0
Accounting Directive	Country-by-country reporting	1
Credit Rating Agencies Regulation (CRA III)	Legal and supervisory frameworks	9

237 Commission Staff Working Document: EU equivalence decisions in financial services policy: an assessment SWD (2017) 102 final
238 Written evidence from Lloyd's and the Lloyd's Market Association (FRS0028)
239 Q 11
240 Q 67

Name of overarching regulation	**Type of equivalence determination**	**Number of countries with determination**
Statutory Audit Directive	Adequacy of competent authorities	16
	Equivalence of audit framework	23
	Equivalence of audit framework: transitional period	4
European Market Infrastructure Regulation (EMIR)	Central banks and public bodies exemption	8
	Regulated markets	5
	Transaction requirements	1
	CCPs	15
	Trade repositories	0
Central Securities Depository Regulation (CSDR)	CSDs	0
Securities Financing Transaction Regulation (SFTR)	Central bank exemption	0
	Trade repositories	0
	Transaction requirements	0
Benchmarks Regulation (BMR)	Requirements for benchmark administrators	0
	Specific administrators or benchmarks	0
Short selling Regulation (SSR)	Requirements for markets	0
Market Abuse Regulation (MAR)	Exemption for monetary and public debt management activities	13
	Exemption for climate policy activities	0
Solvency II Directive	Third-country reinsurers in the EU	3
	EU insurers in third countries	8
	Third-country insurers in the EU	2

Name of overarching regulation	Type of equivalence determination	Number of countries with determination
Markets in Financial Instruments Regulation (MiFIR) and Directive (MiFID II)	Central bank exemption	12
	Derivatives: trade execution and clearing obligations	0
	Trading venues for the purposes of clearing access	0
	Trading venues and CCPs—access to benchmarks and licences for the purposes of clearing and trading obligations	0
	Investment firms providing investment services to EU professional clients and eligible counterparties	0
	Trading venues for the purposes of trading obligations for shares	4
Capital Requirements Regulation (CRR)	Credit institutions	21
	Investment firms	13
	Exchanges	13
	Exposures to central governments, central banks, regional governments, local authorities and public sector entities	21
	Credit institutions	21
	Investment firms	13

Source: European Commission, 'Equivalence/Adequacy Decisions taken by the European Commission as of 9 January 2018': https://ec.europa.eu/info/sites/info/files/overview-table-equivalence-decisions_en.pdf [accessed 19 January 2018]

130. If the UK ultimately has to rely on equivalence, there will be particular concern over continuity, and over the risk of a gap between EU membership ending and equivalence determinations being reached and thereafter maintained. This delay may be significant: the Investment Association noted, for example, that "the European Commission took four years to determine that US regulation of CCPs was equivalent to EMIR. This is despite the differences between US and EU regulation being confined to relatively minor technical issues and the existence of a long-standing forum for regulatory discussions between the EU and US."[241]

131. A further issue is the possibility of the UK being compelled, by virtue of the equivalence regime, to adopt rules that do not fit its domestic market. As Julian Adams of Prudential noted, "Equivalence, as distinct from a

241 Written evidence from the Investment Association (FRS0029)

bespoke mutual agreement/recognition treaty, runs the risk that we become a rule-taker rather than looking at whether our frameworks deliver broadly equivalent outcomes."[242] Andrew Bailey was even more emphatic: "Let me be clear that, if it is a rules-based equivalence, we have the problem that, subject to the institutional arrangements that exist, we would be more of a rule-taker at that point. That is a pretty problematic world to end up in."[243] Barnabas Reynolds agreed that "we do not want to end up a rule-taker". He believed that the reason for the UK's success was its "very subtly crafted laws and regulations for financial services that facilitate dynamic enterprise and competition—the continuation of the City's success. Anything that fetters that would be a trade-off."[244]

132. Witnesses also noted that the terms under which equivalence determinations are rendered are not always clear. Deloitte commented: "There are no detailed rules on how closely a non-EU country's regulation will need to match the EU's in order to obtain equivalence or gain market access. Ultimately much of this will come down to the political will between the parties involved."[245] The insurer Aviva noted the Commission's position (contained in the Staff Working Document) that "it is the equivalence of regulatory and supervisory results that is being assessed, not a word-for-word sameness of legal texts".[246] Richard Knox, of HM Treasury, adopted a similar line:

> "Equivalence is not necessarily rule-taking … Obviously they do not rely on exactly the same rules at a granular level, because the EU and the US rule books are very different. What they provide for, and this is set out in the legislation, is an assessment of whether the rules are equivalent that is based on outcomes rather than line by line."[247]

133. Professor Niamh Moloney, in contrast, doubted whether equivalence would be this flexible in practice: "The EU works on precedents and templates … It is very difficult for it to move from that way of doing business. Having invested in an equivalence system that is predominantly rules-based, although it is moving more into outcomes, it is hard to see how it will shift away from that."[248] This problem is compounded by the nature of the decision-making process, which lies entirely in the Commission's gift, and, as we noted in our December 2016 report, is frequently politicised.[249] Barclays observed that "the UK should encourage the de-politicisation of the equivalence process, or consider alternative mechanisms for future alignment".[250]

134. This raises the question of how far the UK could diverge from the EU's standards under an equivalence framework without the Commission withdrawing the determination. UK Finance were relatively sanguine: "Since, to our knowledge, third country equivalence under EU financial services legislation has never been withdrawn, it is hard to say with certainty

242 Q 80
243 Q 105
244 Q 11
245 Written evidence from Deloitte (FRS0016)
246 Written evidence from Aviva (FRS0032)
247 Q 122
248 Q 3
249 European Union Committee, *Brexit: financial services* (9th Report, Session 2016–17, HL Paper 81)
250 Written evidence from Barclays (FRS0040)

what the threshold for its withdrawal is or will be; it is unlikely to be the same in all contexts."[251] Neena Gill MEP, on the other hand, told us:

> "There will be limited scope [for the UK] to amend its regulatory framework if it wants to remain equivalent. Every divergence has to be negotiated with the European Commission which can withdraw equivalence at any moment … The most probable scenario is that the UK will either be obliged to keep implementing EU law, or it will need to maintain regulation that is close enough to EU standards to enable the UK to achieve positive equivalence assessments from the EU."[252]

UK Finance also argued that the Commission's ongoing review of equivalence "will result in a more stringent approach".[253] The outcomes of the review are still unknown, but the uncertainty underlines the risk inherent in equivalence.

Conclusions and recommendations

135. **The EU's equivalence regime is patchy in composition, and too politically insecure for firms to feel confident in making use of its provisions. It would not allow the highly integrated web of financial services within the EU to persist in anything like its current form. Equivalence provisions are currently undergoing a review; depending on how equivalence is in future interpreted, there is a serious risk that it may leave the UK a rule-taker. And if the UK is no longer able to influence the composition of EU laws, these rules could increasingly become unsuited to the UK financial services sector, which is the largest provider of such services in the EU.**

Political possibilities for a free trade agreement

136. The EU's Chief Negotiator, Michel Barnier, in a press conference on 18 December 2017, commented on the UK's preference for a free trade agreement, saying that the UK had "to realise there won't be any cherry picking … There is no place [for financial services]. There is not a single trade agreement that is open to financial services. It doesn't exist." He said this outcome was a result of "the red lines that the British have chosen themselves. In leaving the Single Market, they lose the financial services passport."[254] John McFarlane confirmed that he had "spoken to some of the people in the EU who are involved in the negotiations and to some of the countries. It has been made very clear that, if you are not a member, you cannot keep the same terms. That has been quite clear. Therefore, there will be less, and we have to work out what that is."[255]

137. In response, the Secretary of State for Exiting the EU, David Davis, in an article on 2 January, challenged Mr Barnier's position: "Given the strength and breadth of our links, a deal which took in some areas of our economic relationship but not others [i.e. excluding financial services] would be, in

---

251 Written evidence from UK Finance (FRS0044)
252 Written evidence from Neena Gill MEP (FRS0013)
253 Written evidence from UK Finance (FRS0044)
254 Jennifer Rankin, 'UK cannot have a special deal for the City, says EU's Brexit negotiator', *The Guardian* (18 December 2017): https://www.theguardian.com/politics/2017/dec/18/uk-cannot-have-a-special-deal-for-the-city-says-eu-brexit-negotiator-barnier [accessed 12 January 2018]
255 Q 114

the favoured phrase of EU diplomats, cherry picking."[256] It will be crucial for businesses to gain insight as soon as possible into the desired scope of this overall agreement, and the place of financial services within it, given the existence of an alternative, unsuitable regime for financial services in the form of equivalence.

138. In its current form, passporting is a function of the Single Market, in that harmonised prudential requirements and the mutual recognition of licences allow banks in the EU to provide services throughout the Union (a right established for banking in 1989 as a result of the second Banking Directive).[257] Sir Jon Cunliffe commented that "I do not think the Bank of England ever assumed that passporting would continue", but added that various possibilities were under consideration, including, at the more comprehensive end of the spectrum, "end states in which the passport might continue, or something like the passport might continue, or in which there is regulatory and supervisory equivalence between the UK and the EU that allows the current level of financial services trade to continue afterwards".[258] Dr Kay Swinburne MEP went further, explicitly challenging Michel Barnier's restrictive understanding of free trade agreements:

> "When we looked at where the TTIP [the Transatlantic Trade and Investment Partnership] discussions were going with the US early on, it was fairly obvious to us that Michel Barnier, when he was Commissioner for Internal Market and Services from 2009 to 2014, drafted a chapter specifically on financial services to be included in TTIP. Indeed, it was the US that said that it did not want to include financial services in that trade and investment partnership. We already have what I would consider a template, written by former Commissioner Barnier himself … I would suggest that, rather than his words of last week … his own chapter on financial services for TTIP might be where we want to look when we start negotiating on financial services in a free trade deal."[259]

139. Various witnesses saw benefit for the EU in adopting an imaginative approach to financial services. Professor Eilís Ferran argued that the gaps in the existing equivalence regime would "have potentially adverse effects for the EU as well as for the UK … there is incentive on both sides to make sure that we can replicate as much as possible of the existing access arrangements".[260] The ICAEW emphasised "that every trade has two sides, so EU-27 consumers of UK services and markets will lose as well as UK providers of those services if their efficacy or availability is impaired. Given the size of the UK markets and financial services sector any such losses will be substantial for both sides."[261]

140. But even though the fragmentation of markets would cause economic damage, there could be political motives for pursuing such an objective. Andrew Bailey told us that "for some countries more than others, this is

256 David Davis, 'How we will deliver the best Brexit in 2018', *The Daily Telegraph* (1 January 2018): http://www.telegraph.co.uk/news/2018/01/01/will-deliver-best-brexit-2018 [accessed 12 January 2018]
257 European Parliament, *Third-country equivalence in EU Banking* legislation (12 July 2017): http://www.europarl.europa.eu/RegData/etudes/BRIE/2016/587369/IPOL_BRI(2016)587369_EN.pdf [accessed 12 January 2018]
258 Q 67
259 Q 136
260 Q 4
261 Written evidence from ICAEW (FRS0046)

a cake-cutting exercise in getting business".[262] Professor Moloney said that "we know from reading the newspapers the play France is making in this direction. It is very clear that, politically, there are incentives to bring business, and that is simply a reality."[263] Stephen Jones added: "We detect some degree of political will in certain parts of continental Europe in order to reclaim what they perceive might be 20 years of lost wholesale financial services to the London market."[264]

Mutual access and alternatives to equivalence

141. We heard significant evidence on the appeal of mutual access, or mutual recognition, as an alternative to equivalence. Rachel Kent, of Hogan Lovells, who worked on an IRSG report on a possible legal framework for a mutual access regime,[265] stated that "a bespoke agreement would provide the most optimal outcome for financial institutions on both sides of the border". Such a regime "would provide mutual access, EU firms into the UK and the UK into Europe, continuing the existing regime. That would obviously avoid the relocation cost and the potential double hit on capital, which would be very inefficient, so critically it provides access."[266]

142. Although the Government is well aware that there is no precedent among existing free trade agreements for such an ambitious mutual recognition regime, covering both financial and non-financial services, there is not a general understanding of this point. The Prime Minister's Florence speech highlighted the limitations of existing models such as the EU-Canada FTA (CETA), concluding that "compared with what exists between Britain and the EU today, it would nevertheless represent such a restriction on our mutual market access that it would benefit neither of our economies"; she therefore urged negotiators not merely "to adopt a model already enjoyed by other countries", but to "be creative as well as practical in designing an ambitious economic partnership which respects the freedoms and principles of the EU, and the wishes of the British people".[267]

143. The difficulty of extending the principles of mutual recognition to services is widely acknowledged. John McFarlane, Chairman of Barclays, stated: "You are correct about financial services not being in trade agreements; for example, Switzerland has well over 100 trade agreements with the EU, but not one of them is on services." This was a matter of particular concern to the UK: "Services are 80% of this economy. Financial services and related professional services are about 10% of GDP. We are dealing with quite an important matter for the United Kingdom, and I would have thought that should be a priority."[268]

144. References to 'mutual recognition' or 'mutual access' regimes in respect of financial services are thus necessarily speculative. Stephen Jones of UK

262 Q 102
263 Q 7
264 Q 33
265 International Regulatory Strategy Group, *A new basis for access to EU/UK financial services post-Brexit* (September 2017): https://www.irsg.co.uk/assets/IRSGNewBasisForAccessweb.pdf [accessed 12 January 2018]
266 Q 23
267 Rt Hon Theresa May MP, speech on 'a new era of cooperation and partnership between the UK and the EU' (22 September 2017): https://www.gov.uk/government/speeches/pms-florence-speech-a-new-era-of-cooperation-and-partnership-between-the-uk-and-the-eu [accessed 17 January 2018]
268 Q 111

Finance distinguished mutual recognition from the EU's existing equivalence regime: "Equivalence can result in an asymmetric approach where you become a rule taker. From our perspective, a mutual recognition model is one where you have a symmetric approach where both parties are submitting themselves to mutual scrutiny of one another's proposed regulations", and the consequences of regulatory divergence would include the possibility of dissolution of the agreement.[269] Several industry bodies have put out proposals on what such a mutual recognition regime might look like from the perspective of financial services, including UK Finance and the IRSG.[270]

145. Some witnesses suggested that international standards might form the basis of a mutual access regime. The Minister argued that "international standards … provide the framework through which we can look at an ambitious deal between the UK and the EU".[271] Barnabas Reynolds agreed: "Where there are international standards, we would take those to be the defined outcomes. Both the EU and the UK would apply them anyway; we have been party to developing them in international fora."[272] Professor Eilís Ferran was more cautious: "The suggestion that we could move to higher-level international standards and benchmarks for checking parity is interesting. I could see it working in some areas where we have international standards that are reasonably well developed; in other areas … it is harder to see a standard that is fit for purpose in that respect."[273]

146. An alternative suggestion, made to us by Barnabas Reynolds, was a regime founded on 'enhanced equivalence'. This would involve adapting the EU's current equivalence framework by developing a generalised concept of equivalence. Equivalence judgements would then be based on outcomes (as is the case in MiFID II), rather than rules. Mr Reynolds told us: "That would be for the benefit of the EU, effectively, because it is still incomplete; there are gaps in it and some things that can be rationalised. We would then provide for two-way certainty between the EU and the UK." Additional elements would then be dealt with through "a bilateral deal between the UK and the EU that would be entered into on Brexit, and would provide for procedural certainty in March 2019".[274]

147. Such an approach would require the EU to legislate in order to implement such a regime before the UK's exit. From Mr Reynolds' perspective, this was an advantage: "If we went down the enhanced equivalence route, it would involve the EU making a new regulation, which the UK could help to pilot through the Council, under QMV, and the European Parliament, where a majority is required, before Brexit … As long as that was achieved by Brexit, it would come into the UK system automatically through the [Withdrawal] Bill, providing the same framework on both sides, effectively."[275] He felt this would be more achievable than an FTA. Mark Hoban was more doubtful,

269 Q 33

270 Written evidence from UK Finance (FRS0044); see also IRSG, *A new basis for access to EU/UK financial services post-Brexit* (September 2017): https://www.irsg.co.uk/assets/IRSGNewBasisForAccessweb.pdf [accessed 12 January 2018] and UK Finance, *Supporting Europe's economies and citizen's: a modern approach to financial services in an EU-UK trade agreement* (September 2017): https://www.ukfinance.org.uk/wp-content/uploads/2017/11/EU-UK-Trade-Agreement-report-ONLINE-UPDATED.pdf [accessed 16 January 2018].

271 Q 121

272 Q 11

273 Q 3

274 Q 11

275 Q 12

describing the need to secure legislative agreement as "challenging". He also noted that if enhanced equivalence were to be pursued, "it would not just be a bespoke UK model, so there would be some resistance perhaps to creating a model that would apply to the US, to China, to Japan et cetera."[276]

148. Simon Gleeson of Clifford Chance, took a step back, suggesting that the focus on mutual equivalence versus mutual recognition was misplaced, in that both could allow for the same outcome: "It is important to avoid getting bogged down in legal technicalities. There is no practical difference between a mutual recognition agreement and a mutual equivalence arrangement; they are functionally identical."[277] Each would be put into law in different ways, but Mr Gleeson was sanguine that both could deliver comparable degrees of market access. Mark Hoban, however, argued that there was a distinction, in that "with enhanced equivalence, it would still be within the control of the Commission to determine equivalence, and it would be subject to the ECJ".[278]

Conclusions and recommendations

149. **There are various legal means by which to facilitate mutual access. Equivalence, as currently framed under EU law, would not be sufficient, but could, with political will, potentially provide a basis for negotiating a more comprehensive agreement in the form of an 'enhanced equivalence' regime. A free trade agreement, or a separate bilateral agreement on mutual market access, would achieve a similar result.**

150. **An agreement granting secure, symmetric access would be to the mutual economic advantage of both the UK and the EU, but significant political hurdles remain. The Government, in approaching the next phase of negotiations with the EU, must work to foster the goodwill and understanding necessary to achieve this goal.**

Divergence and the architecture of market access

151. The Prime Minister stated in her Florence speech that "We start from an unprecedented position. For we have the same rules and regulations as the EU … So the question for us now in building a new economic partnership is not how we bring our rules and regulations closer together, but what we do when one of us wants to make changes."[279] The management of divergence will be the crux of the future relationship. The other side of the coin is regulatory alignment, which in financial services serves to facilitate limited access for third countries under the EU's equivalence regimes, and could potentially provide the foundation for a more far-reaching agreement.

152. While the UK is currently fully compliant with EU financial services law, the issue after Brexit will be how divergence is managed. Jonathan Herbst argued that "if one can come to some core standards that are recognised as the basis for equivalence, it is fine if there is then divergence to a higher standard".[280] Simon Gleeson, on the other hand, warned of "the risk … that you get divergence for good reasons with good faith on all sides, which

276 Q 21
277 Q 11
278 Q 21
279 Rt Hon Prime Minister Theresa May MP, speech on 'a new era of cooperation and partnership between the UK and the EU' (22 September 2017): https://www.gov.uk/government/speeches/pms-florence-speech-a-new-era-of-cooperation-and-partnership-between-the-uk-and-the-eu [accessed 12 January 2018]
280 Q 15

ends up with each side accusing the other of having different standards".[281] The UK may, post-Brexit, wish to set its own course in areas where EU rules have not proved themselves particularly suitable to the UK's domestic market (see Chapter 7). The EU may also initiate divergence, for instance by advancing regulatory initiatives designed for the EU-27, such as Capital Markets Union.

153. Any mechanism designed for managing divergence (other than equivalence, which is arbitrated by the Commission) would need to be anchored by a form of dispute resolution.[282] Such a mechanism may be unique to financial services, or more broadly applied across the whole of a mutual access regime. In the Prime Minister's Florence speech, she stated that dispute resolution "could not mean the European Court of Justice—or indeed UK courts—being the arbiter of disputes about the implementation of the agreement between the UK and the EU … But I am confident we can find an appropriate mechanism for resolving disputes."[283] Rachel Kent noted that "free trade agreements frequently have dispute resolution mechanisms. They are frequently an independent body. They are not normally the ECJ."[284] Andrew Bailey agreed: "If there is, let us say, some form of mutual recognition agreement between the UK and the EU that governs open markets and financial services, which I think would be a good thing, there will need to be a form of dispute resolution."[285]

154. Neena Gill MEP argued that "consideration could be given to a European Free Trade Area (EFTA) Court as an ad-hoc international court which has jurisdiction with regards to EFTA States that are parties to the EEA agreement (at present Iceland, Liechtenstein and Norway)".[286] This option appears, however to have been ruled out by the Government, at least as a basis for the future relationship.[287]

155. An essential backstop to dispute resolution will be supervisory cooperation (see Chapter 6). In the words of Rachel Kent of Hogan Lovells: "We heard strongly from regulators on both sides that there is no point in having regulatory alignment without having supervisory co-operation."[288] Sir Jon Cunliffe agreed that "we have to have both high-quality regulation and the comprehensive supervisory co-operation".[289] Andrew Bailey developed these points:

> "The assumption is that the UK is not subject to ECJ rule at that point. At a lower level, it would need to replicate the type of mediation

---

281 Q 15

282 The EU Justice Sub-Committee is currently undertaking an inquiry on dispute resolution, announced 6 December 2017. For this reason, we have refrained from assessing dispute resolution mechanisms in detail. See EU Justice Sub-Committee, 'Brexit: enforcement and dispute resolution inquiry': http://www.parliament.uk/business/committees/committees-a-z/lords-select/eu-justice-subcommittee/inquiries/parliament-2017/brexit-enforcement-and-dispute-resolution/ [accessed 12 January 2018]

283 Rt Hon Prime Minister Theresa May MP, speech on 'a new era of cooperation and partnership between the UK and the EU' (22 September 2017): https://www.gov.uk/government/speeches/pms-florence-speech-a-new-era-of-cooperation-and-partnership-between-the-uk-and-the-eu [accessed 12 January 2018]

284 Q 23

285 Q 104

286 Written evidence from Neena Gill MEP (FRS0013)

287 Rt Hon Prime Minister Theresa May MP, speech on 'a new era of cooperation and partnership between the UK and the EU' (22 September 2017): https://www.gov.uk/government/speeches/pms-florence-speech-a-new-era-of-cooperation-and-partnership-between-the-uk-and-the-eu [accessed 12 January 2018]

288 Q 23

289 Q 70

> arrangements that we are currently subject to in the European Supervisory Authorities, where there is binding and non-binding mediation. It is not used very often, but it is an important thing to have."[290]

156. Jonathan Herbst, on the other hand, saw supervisory cooperation as distinct from any free trade agreement:

> "We are talking about two different things. There is the international supervisory co-operation that happens already between EU jurisdictions and those outside. That will and should carry on. Then there is what we might be talking about in a free trade agreement, which will be much deeper and more legally based because there will be real sharing of power. They are two quite different things. The first can be achieved through supervisory relationships and MoUs; the second will need something more hard coded in law."[291]

Conclusions and recommendations

157. **We conclude that the current equivalence regime would fail to provide the level of market access for financial services that both sides require, and that it would inhibit the UK from developing an appropriate regulatory framework. The Government should not settle for an agreement based on equivalence without securing substantial changes to that regime.**

158. **There are various possibilities for a future agreement covering financial services. These include a free trade agreement to include services, a standalone mutual recognition regime, and possibly some form of so-called 'enhanced equivalence'. We do not come to a view on which of these would be preferable, although all would be more satisfactory than equivalence. However, it has to be acknowledged that free trade agreements take time, sometimes years, to agree, and there is no precedent for an agreement on the scale that the Government seeks.**

159. **Whichever option is pursued, it will be vital to put in place a robust dispute resolution mechanism, which is as yet undetermined. This may require new institutions to arbitrate such matters, or involve existing courts. The Government should make clear which arrangements it favours, given its well-publicised red line on the jurisdiction of the Court of Justice of the European Union.**

160. **We recognise that the EU, or individual Member States, may be politically motivated to reject a bespoke agreement regarding future access. However, such an agreement would be in the overriding economic interest of all sides. Without it, EU counterparties stand to lose the substantial benefits that come from being able to draw on the services offered by the UK. The EU has in the past shown ambition and imagination in seeking to include financial services in the TTIP free trade negotiations. We urge all sides to show similar imagination in negotiating the future UK-EU partnership.**

---

290 Q 104
291 Q 16

CHAPTER 6: SUPERVISORY COOPERATION

The terrain of supervisory cooperation

161. Supervisory cooperation is an established element within the EU's supervision of cross-border banking and insurance groups and financial market infrastructures. National Competent Authorities (NCAs) participate in supervisory colleges, reaching joint decisions on prudential requirements to be placed on firms; NCAs also sit on the boards of the ESAs and enter into memoranda of understanding and cooperation agreements with other regulators; and there are day-to-day bilateral relationships between NCA staff at the working level.

162. Sam Woods outlined the forms of supervisory cooperation extant within the EU: "There is a quite highly developed institutional and regulatory architecture around this business of supervisory co-operation, and the best example of that is this thing called the JRAD process, which is the Joint Risk Assessment and Decision." Mr Woods explained that under the JRAD process, a supervisory 'college' is formed, which "comprises the group supervisor of, say, a bank—it is also true for insurance companies—the supervisor of any subsidiary of any size, and the supervisor of any significant branch, but not of other branches". The college makes decisions on supervisory issues such as capital requirements, which are "taken by the group supervisor and the supervisor of the subsidiaries, but not by the branch supervisor". Mr Woods therefore concluded: "There is a structure of that kind that we work with today, and that works fine."[292]

163. Mr Woods explained that arrangements are different with respect to third countries—in other words, non-EU Member States:

> "We have a different model with third countries, and I give the US as an example, where we agree an MoU, and the MoU does two things. One is that it allows the data to flow back and forth, but secondly it has a split of responsibilities: 'Here is what you are doing, and here is what we are doing'. That is a lighter machinery. With the right level of trust and co-operation on the other side, though, that is also an effective machinery."[293]

164. We heard a significant amount of evidence on what Brexit might mean for future cooperation between supervisors and the forms it might take. Several witnesses noted the contribution the UK made at the technical level, and suggested that the UK's expertise meant that it might maintain some form of influence at the level of supervisory cooperation. For instance, the European Securities and Markets Authority (ESMA) is the ESA responsible for regulating financial markets and enhancing investor protection; KPMG commented that "with its extensive experience in wholesale markets, the FCA has played a central role in the technical rulemaking of ESMA".[294] The influence of the FCA within ESMA was also highlighted by Jonathan Herbst: "There was concern that after the [Brexit] vote the FCA would lose its role on ESMA. That did not happen, and one of the main reasons was that ESMA wanted the technical expertise. Obviously, things will be different after exit, but you can build something."[295]

292 Q 73
293 Q 73
294 Written evidence from KPMG (FRS0043)
295 Q 15

165. Simon Lewis recognised the depth of expertise that the UK has contributed in a supervisory capacity, and suggested that alternatives to ESA board membership may be found, in the form of "some sort of advisory board or some sort of college that can be established so that people of the quality of Andrew Bailey and Sam Woods can continue to contribute to the work of the ESAs". He argued that there was "wide acceptance in the EU that the UK has played a very important and influential role in the development of the regulatory structure. There is, therefore, an understanding that if we can find a way of accommodating that expertise, that would be good for Europe's capital markets."[296]

166. Professor Niamh Moloney agreed that the ESAs would "have an interest in ensuring that they pull in technical expertise", but reminded us of "the level at which influence would be exerted".[297] The UK currently contributes at a range of levels within the ESAs, from the board of supervisors to working groups drafting level 2 and 3 technical standards and supervisory guidelines. The question of the level within the ESAs at which influence would be exercised was also addressed by Professor Ferran: "By being involved not just in the board of supervisors but in the more technical committees and working groups below, we can have soft power and influence, but it is a downgrade from where we are." [298]

167. Simon Gleeson told us that supervisors were "absolutely certain that close co-operation is the only way forward and anything less than that will render the entire system significantly less safe".[299] He continued: "It is now absolutely clear that the G6—the globally systemically important banks—are not just the problem of the supervisor in the country where they are incorporated; they are everybody's problem."[300] Simon Lewis emphasised that "there is a very strong will around joint supervision, and often these joint supervisory roles are based on strong personal relationships. From my perspective, there is a huge amount of personal respect within the EU among the regulatory community."[301] Indeed, as Karel Lannoo noted, supervisory cooperation already exists: "The structures that we have in place today, and had even before the crisis, of supervisory colleges for banks, insurance companies and even infrastructure should continue to be in place."[302]

168. The possibility of the UK participating as an observer on ESA boards was mentioned by several witnesses. Dr Kay Swinburne MEP suggested that the EU might consider "opening up these fora to external observers, so that there would at least be a confidential dialogue amongst regulators about the direction of travel and perhaps a greater, more detailed dialogue about technical aspects of regulation".[303] However, the limitations of observer status were also recognised. Professor Niamh Moloney cautioned that "you are in the room at the highest level; by the time something has got to the board of supervisors it is very much at the level of contestation on big principled points".[304] Dr Swinburne discussed observer status in the context of the

296 Q 34
297 Q 5
298 Q 5
299 Q 15
300 Q 16
301 Q 34
302 Q 131
303 Q 144
304 Q 5

ECON Committee: "People can sit and observe, but they obviously do not contribute in any meaningful way."[305] Professor Eilís Ferran noted that there were conditions associated with observer status: "There are arrangements regarding staff and financial contribution and for the adoption or following of EU law; and you do not get a vote."[306]

The review of the ESAs

169. In our Call for Evidence (see Appendix 3), we asked about the review of the ESAs that the Commission was conducting at that time, including the key areas in which reform should be pursued, and what the potential impact of such changes would be on the UK. On 20 September 2017 the European Commission published an omnibus package of legislative proposals following on from the ESA review.[307] The package proposes alterations to the powers, funding and governance of the ESAs. The fundamental aim is to promote supervisory convergence: this is in part achieved by transferring supervisory powers from NCAs to the EU and enhancing cooperation.

170. Witnesses considered how desirable such centralisation of powers would be and how it might affect UK and EU domestic authorities. Both AFME and Clifford Chance were in favour of the ESAs playing more of a role in equivalence determinations, as a means of depoliticising the process. AFME stated that the ESAs "could strengthen their valuable role in providing more resource and technical advice in the context of equivalence assessments and ongoing monitoring of equivalence". They could, for example, be tasked with monitoring "the regulatory, supervisory and market developments in third countries while leaving the ultimate decision on the third country equivalence status with the European Commission".[308]

171. Clifford Chance agreed, adding that "it is advantageous for the UK authorities to be able to deal with a single EU voice rather than a plethora of national voices".[309] While this already appeared to be the case within the banking industry, the position for insurance and securities regulation left UK firms with a "'who do I speak to when I want to speak to Europe' problem. Consequently the UK should encourage the EU to unify its securities and insurance regulatory policymaking at an EU level to the greatest degree permissible under the existing EU treaties."[310] Simon Gleeson endorsed the policy aims of the omnibus package, connecting it with the EMIR review: "It is unquestionably right that the ultimate aim of European policy-making is a single securities regulator."[311] He also sought coordinated engagement

305 Q 144
306 Q 5
307 Proposal for a Regulation of the European Parliament and of the Council Amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority); Regulation (EU) No 1094/2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority); Regulation (EU) No 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority); Regulation (EU) No 345/2013 on European venture capital funds; Regulation (EU) No 346/2013 on European social entrepreneurship funds; Regulation (EU) No 600/2014 on markets in financial instruments; Regulation (EU) 2015/760 on European long-term investment funds; Regulation (EU) 2016/1011 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds; and Regulation (EU) 2017/1129 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, COM(2017) 536 final
308 Written evidence from AFME (FRS0021)
309 Written evidence from Clifford Chance (FRS0039)
310 Written evidence from Clifford Chance (FRS0039)
311 Q 16

with Europe, and believed that there would be further transfers of power, "with the aim of trying to turn ESMA into a single European securities supervisor":

> "It seems to me to be a very good thing for the UK, and I wish it was happening faster. If our securities regulator had a single European securities regulator to talk to, the dialogue would be much more efficient than where we will end up if the securities regulator in the UK has to maintain dialogue with 27 different securities regulators, ESMA and the Commission. At the moment, the fragmented nature of supervision in Europe in that direction is an obstacle to the development of sensible relationships between the UK and the EU."[312]

172. Jonathan Herbst, in contrast, questioned the value of any centralisation of power within ESMA: "It will depend on how ESMA uses its powers. If it is, essentially, to lock out the UK, a degree of member state discretion could be very beneficial. We are already seeing examples of that, with different member states taking slightly different approaches. I am not entirely convinced that the federal solution is good for us."[313]

173. In contrast, John McFarlane was sanguine about centralisation of supervisory powers within the EU more generally: "While it is theoretically a concern, personally, I am not ultra-concerned about it. We have US dollars overseen by the Fed. We are quite used to that. We are quite used to euro activities being overseen by the ECB and others. That will continue post Brexit. I cannot imagine that it will change." Given that other European regulators "are all part of the Financial Stability Board and that global standards are likely to apply, and given that national standards in the EU will not necessarily apply to cross-border activity, I think this will all sort itself out".[314]

The challenges and opportunities of joint supervision: CCPs

174. Regardless of whether or not there is an agreement on market access, the need for supervisory cooperation will remain. Issues of joint supervision are especially important to the clearing industry. The European Market Infrastructure Regulation (EMIR), which was adopted in 2012 in the wake of G20 commitments, requires that most OTC (over-the-counter) derivative contracts be cleared via clearing houses (known as central counterparties, or CCPs). EMIR mandates CCPs to be authorised by a cross-border college of supervisors in order to offer clearing services in the EU; once authorised, EU firms can use the CCP in order to fulfil their clearing obligations under EMIR. ESMA participates in the colleges that govern the registration and supervision of CCPs, and UK CCPs are authorised jointly by the Bank of England and ESMA. The FCA also currently works closely with ESMA. Measures adopted to supervise clearing houses may therefore serve as a model for potential supervisory cooperation in other fields.

175. Dr Kay Swinburne MEP has been closely involved in the development of the EU's regime on clearing, and told us about the progress that had been achieved: "The EMIR legislation has become the gold standard throughout

312 Q 16
313 Q 16
314 Q 115

the rest of the world.” She explained that EMIR instituted a variety of risk management strategies:

> “Rules were put in for a very extensive default waterfall, where everyone knew up front what they were committing themselves to in risk management, what tools were allowed to be used by the CCP on their behalf and how the risk would be mutualised through the system, depending on what had happened.”[315]

She then referenced a proposal currently under consideration,[316] on which she is the co-rapporteur:

> “The final piece of that jigsaw is recovery and resolution, which is what happens when you get to the end of the default waterfall and you need to find additional tools either to resolve or to continue the business, if it is a critical function, for market stability.”[317]

176. The Commission is also currently consulting on proposals to amend EMIR itself.[318] The proposals as they stand—which are under discussion in the Council—would entail greater EU oversight and potentially the compulsory relocation of third-country CCPs to the EU. Under the Commission’s draft text, the legislation would create a category of third-country systemic CCPs subject to the possibility of de-authorisation where joint supervision is judged by the EU not to adequately contain risk. The ECB has likewise requested greater authority over clearing systems, via an amendment to Article 22 of its statute, currently pending approval by the Council and European Parliament.[319]

177. Witnesses described the EMIR proposals as the source of greater concentration of power within the ESAs, especially ESMA. Simon Puleston Jones of the FIA summarised the proposals thus: “What we are seeing through the EMIR agreement is a greater centralisation of powers in ESMA when it comes to the supervision of European clearing houses. To the question, ‘From outside Europe, to whom do I pick up the phone if I want to speak to Europe?’, the answer is ESMA.” He explained that “ESMA would have a greater ability to access information related to third-country clearing houses, as well as the right to visit locally on the ground to check compliance”.[320] ESMA would in consequence have a greater degree of control over third-country CCPs than is the case today.

178. Simon Lewis was positive about the changes, describing them as a “very sensible step forward”. He was of the view that, given the importance of CCPs, “to have an additional level of supervision—so in addition to

315 Q 138

316 Proposal for a Regulation of the European Parliament and of the Council on a framework for the recovery and resolution of central counterparties and amending Regulations (EU) No 1095/2010, (EU) No 648/2012, and (EU) 2015/2365, COM (2016) 0856 final

317 Q 138

318 Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority) and amending Regulation (EU) No 648/2012 as regards the procedures and authorities involved for the authorisation of CCPs and requirements for the recognition of third-country CCPs, COM (2017) 0331 final

319 Commission opinion of 3 October 2017 on the Recommendation of the European Central Bank for a Decision of the European Parliament and of the Council amending Article 22 of the Statute of the European System of Central Banks and of the European Central Bank, C(2017) 6810 final

320 Q 57

the NCA, to have ESMA providing supervisory oversight—we think is a good development … it is a rather good example, if I may say so, of joint supervision. The combination of a pan-European supervisor with the local NCA should reassure people that CCPs will be supervised more effectively." He cautioned, however, that "the devil as always will be in the detail".[321]

179. Daniel Maguire, of the London Clearing House, also recognised the desire of the Commission to centralise the supervision and regulation of CCPs, acknowledging that "ESMA is well placed to do that". However, he wished "to ensure that all the jurisdictions we are regulated by and all the authorities or supervisory bodies overseeing this have the right skill set, competencies and so on".[322] He believed that ESMA might need to develop its resources in future.

180. Mr Maguire was also concerned about the location policy, noting that it was not automatic that, if relocation were enforced, it would benefit the EU: "When you start to consider that location, the answer is not necessarily relocation to Europe; the answer may be relocation going the other way—to the States. This is an internationally integrated market and, if things did need to move, it is not a fait accompli that business would move to Europe."[323]

181. The City Minister, Stephen Barclay MP, also focused on the disadvantages of relocation:

> "If one was pursuing a policy in Europe of domiciling euro clearing back to Europe, the consequence would be less diverse and less liquid, with more market fragmentation, higher cost and more financial instability … I do not think that is in the interests of the Europeans, nor is it in the interests of the UK."[324]

182. Mr Maguire added that relocation would compromise some of the risk mitigation features of central clearing, in particular the netting of different exposures:

> "The whole concept of a clearing house in multi-currency derivatives comes back to the points we were discussing earlier around having everything as much as possible in one place. The idea of splitting pieces up is not in the interest of many … once you get into the detail of globally integrated markets, this is not a zero-sum game. This is a situation where, if you split the liquidity out, both sides will lose."[325]

183. On alternatives to relocation, Mr Puleston Jones foresaw "a world where the most proportionate outcome in order to manage [concerns about euro clearing occurring offshore in a crisis] is to have an enhanced co-operation arrangement between the European and UK regulatory authorities". He explained that there was "already a model for that between the CFTC in the US and the Bank of England". Such an agreement, in which it is determined "at the outset, if a UK clearing house or a US clearing house were to default,

321 Q 39
322 Q 58
323 Q 58
324 Q 124
325 QQ 58–59

what those clearing houses would do", would, he felt, address concerns about oversight during a crisis. He highlighted a number of pertinent questions:

> "What would the supervisory authorities do? Who would be in control of making what decisions? Who has the final say? To what extent might Europe and European authorities, including the central banks, be involved in the decision-making process, whether that be in the default of the CCP or, absent the default of a CCP, another euro crisis, as we had at the beginning of this decade?"[326]

184. Sir Jon Cunliffe took a similar view:

> "What I see in the European proposals, which have a number of different models and a tiering of different sorts of CCPs, is recognition of this need to reflect the multilateral nature of CCPs, and recognition that you need to defer to the home supervisor but there have to be some arrangements between them. Even if we were not going through Brexit, we would have to develop the way we supervise and regulate these critical pieces of international infrastructure, simply because of this co-ordination issue."[327]

185. Dr Kay Swinburne MEP also emphasised the degree of cooperation that is already in place for CCPs: "We have got to the stage where co-operation between regulators for CCPs is extensive and frequent." This was particularly the case with respect to the information exchange that underpinned cooperation, which "now happens not just regularly but daily … It is also very detailed, in a way that never happened before, so I am convinced that the risk management procedures within the globally systemic CCPs, of which there are very few, are much stronger than they ever were."[328]

Conclusions and recommendations

186. **The Commission's proposed revisions to EMIR contain both good and bad elements. Giving ESMA additional powers of oversight will help reassure financial market participants, especially to the extent that this will involve cooperation with the NCAs. However, proposals to demand the relocation of systemic CCPs within the eurozone will not achieve the Commission's objectives of bolstering financial stability. They will instead increase costs to market participants, particularly those inside the EU-27; cause fragmentation, by reversing G20 measures taken to contain risk within CCPs; and result in the loss of clearing business for both the UK and EU-27, as clearing members move their positions to New York. The Government should resist these measures by whatever means possible.**

187. **The existence of supervisory colleges, and the relationships between third-country NCAs and ESMA, could serve as a template for future supervision of financial market infrastructures. To the extent that such supervisory cooperation promotes financial stability, as would be the case with the proposals to revise EMIR, it may also obviate the need to relocate those infrastructures within the EU. Further measures to enhance such cooperation within the European legislative**

326 Q 57
327 Q 75
328 Q 138

structure should therefore be encouraged, although proposals to centralise authority in ESMA will need to be carefully scrutinised.

188. **The evidence we heard consistently highlighted the strength and depth of existing supervisory cooperation and the extent of the EU's reliance on the UK's contribution. While the UK's technical expertise is an asset for the EU, the Government should not treat this as a guarantee that the UK will be able to continue to contribute to the decision-making process. We therefore urge the Government to seek to secure continued participation for UK regulators at all levels of the supervisory architecture post-Brexit, to be imaginative in developing new forms of cooperation, and to continue to invest in international and bilateral relationships.**

CHAPTER 7: REGULATORY INNOVATION, FINTECH AND THE FUTURE

Areas where autonomy would be desirable

189. Some areas of the EU's current regulatory framework have proved problematic in the UK context. The EU, according to UK Finance, "has always faced the challenge of regulating a market with an exceptionally diverse set of financial services businesses",[329] resulting in compromise solutions on legislation that are not always coherent when applied to domestic markets. Lloyd's accordingly concluded that "the process of arriving at a level playing field can have disadvantages … Wide variations in regulatory approaches exist between jurisdictions."[330] Brexit may, therefore, present an opportunity for the UK to amend its regime in order to make it more fit for purpose.

190. The UK may also look to develop more innovative regulatory initiatives in order to reflect market strengths, rather than to rectify deficiencies in the existing regulatory framework. The UK is currently a world leader in FinTech, which, as we heard, had been fostered by regulators through projects such as the FCA's regulatory 'sandbox'.

191. Furthermore, financial markets are also capable of innovating through periods of disruption. As Professor Moloney put it: "They find a way … The history of financial markets is that they find solutions to difficulties … It may be that in so doing they make better, more efficient pipelines, products and technologies, using more efficient ways."[331]

192. With respect to the current regulatory framework, the two concerns highlighted most often in this inquiry related to EU's regime for insurers, and to the regulatory requirements to which domestic firms, often smaller, have been subject. We heard that there might be opportunities, post-Brexit, to tailor the UK's regulatory regime so as to rectify these shortcomings.

193. We also heard concerns on the Interchange Fee Regulation; the second Payment Systems Directive; the MREL (Minimum Requirement for Own Funds and Eligible Liabilities) regime; MiFID II; bonus caps; the Short Selling Regulation; the Packaged Retail and Insurance-based Investment Products Regulation; the Deposit Guarantee Scheme Directive; and IFRS 9. We did not, however, receive enough evidence on these measures to reach a view on them.

Solvency II

194. There are areas of the UK regime that have incorporated EU standards in ways that may have been detrimental to the UK's domestic market. Particularly highlighted by witnesses was the Solvency II regime for insurance, which establishes the amount of prudential capital that insurers must hold in order to reduce the risk of insolvency. Julian Adams of Prudential told us: "There are a number of aspects of Solvency II that not just the industry but the regulator does not think work appropriately."[332] Andrew Bailey concurred: "The problem with Solvency II is that it goes much more into the area of national retail markets."[333]

329 Written evidence from UK Finance (FRS0044)
330 Written evidence from Lloyd's and the Lloyd's Market Association (FRS0028)
331 Q 9
332 Q 80
333 Q 105

195. The issue raised most frequently was the 'risk margin'. This is an insurer's additional capital requirement over and above the basic requirement, which serves as the extra capital a third party would need to take over and meet the obligations of the insurer in the event of its failure. Objections to the risk margin turn on the methodology used to calculate it, which is sensitive to long-term interest rates—in an environment with persistent low rates, the risk margin is substantial. Mr Adams told us: "Post Brexit, we would argue that that is a good example where an EU directive does not work appropriately for the UK, and we should have the policy freedom to change it."[334]

196. The ABI also supported a review of the Solvency II regime: "Now would be an opportune time for the UK to review how the Solvency II regime is working in practice and see where there are opportunities to strip away some of the complexity and bureaucracy."[335] The risk margin was their chief concern: "Its size and sensitivity to interest rate movements are both significantly higher than expected and reflect unintended consequences of its design. This makes the writing of new business, in particular annuities and other long-term guarantee-based products, unattractive to firms."[336] Mr Adams confirmed that the risk margin requirement had had a direct effect on Prudential, which had withdrawn from writing individual annuities as a result.[337] This concern was echoed in written evidence from the Equity Release Council, the Institute and Faculty of Actuaries, and Aviva.[338]

197. Andrew Bailey, asked about the appropriateness of Solvency II for the UK market, responded:

> "The lesson I would draw on insurance is that EU regulation has been more effective when it has been directed at wholesale markets that operate across the Union in a fairly homogeneous fashion … The issue, particularly in life insurance, is that national markets in products are not homogenised across the EU, and there is no reason why they should be. Although it is changing with the pension freedoms, the UK has a history of using a much larger annuity market, for instance."[339]

198. Some witnesses, though, did not favour substantial change. The London Market Group maintained that its "members believe that Solvency II's fundamental principles are sound", and that it "should continue to be the basis of UK insurance regulation".[340] This would both maintain regulatory alignment and avoid the costs of changing the regime. Bupa were even more forceful, stating that they "would strongly discourage any further major changes given that the insurance industry is still only now fully embedding Solvency II".[341] The Lloyd's Market Association also "would not support an approach to insurance regulation in the UK which sought substantially to revise the existing regime, based on Solvency II. This would give rise to unnecessary costs and upheaval and would probably make it impossible to retain market access between the UK and the EU."[342]

334 Q 80
335 Written evidence from ABI (FRS0008)
336 Written evidence from ABI (FRS0008)
337 Q 89
338 Written evidence from Equity Release Council (FRS0017), Institute and Faculty of Actuaries (FRS0031) and Aviva (FRS0032)
339 Q 105
340 Written evidence from the London Market Group (FRS0020)
341 Written evidence from Bupa (FRS0038)
342 Written evidence from Lloyd's and the Lloyd's Market Association (FRS0028)

199. Some witnesses claimed that some of the problems with Solvency II were in fact a result of the UK's 'gold-plating' of EU legislation. The insurance group Zurich claimed that UK regulation already went beyond what Solvency II strictly required, and were concerned that further divergence in regulation could "skew financial market activity to locations where rules were less onerous".[343] The Lloyd's Market Association agreed: "There are areas where the UK's regime imposes particular burdens on UK undertakings which are not based on EU legislation. An example is provided by Pillar III supervisory reporting."[344] The ABI and Aviva also claimed that some problems with Solvency II stemmed from the UK's domestic interpretation.[345] Such examples underline the flexibility that is already allowed in the application of EU rules.

Conclusions and recommendations

200. **While there might be reason to change some aspects of Solvency II, the benefits of flexibility will in all cases need to be balanced against the possible consequences of regulatory divergence. The key issue raised in evidence to this inquiry was the risk margin. The Government and regulators should consider whether Solvency II requirements need to be updated in order to reflect the specificities of the UK insurance market, within the bounds of whatever agreement is reached with the EU on future market access.**

Regulatory burdens on smaller firms

201. The second aspect of the UK's current regime, as derived from EU regulation, that was cited as problematic was the regulatory treatment of smaller firms operating domestically rather than internationally. As the ICAEW pointed out, this has been especially problematic in the context of prudential standards, as "the approach to bank capital is an area where there have been differences between the international and EU approaches". They explained: "The Basel Accord was originally intended for internationally-active diversified banks. In the EU (CRD IV, CRR) we have elected to apply the same Basel rules to all banking and investment firms. The US, in contrast, has not. It applies the Basel rules only to its international banks."[346] The Building Societies Association also noted that "for essentially domestic institutions, such as building societies, market access to other member states is less important", and argued that the EU's requirements for uniformity could be "costly and burdensome", reducing competition and diversity.[347]

202. Some witnesses therefore advocated distinguishing between internationally-active institutions and domestic firms. The Building Societies Association argued that UK domestic retail firms and consumers could benefit from being able to follow a UK-only regime, as long as there was "simplicity and clarity for consumers".[348] The Equity Release Council, in the context of insurance rather than banking, said that it would be possible to "operate a split domestic regime, with a version of domestic requirements which has Solvency II equivalence, which domestic firms could choose to meet the requirements of if they wished to operate across the EEA, and a 'core' set

343 Written evidence from Zurich (FRS0042)
344 Written evidence from Lloyd's and the Lloyd's Market Association (FRS0028)
345 Written evidence from ABI (FRS008) and Aviva (FRS0032)
346 Written evidence from ICAEW (FRS0046)
347 Written evidence from the Building Societies Association (FRS010)
348 Written evidence from the Building Societies Association (FRS010)

of domestic requirements which would otherwise apply".[349] The Investment and Life Assurance Group similarly endorsed "a two-tier arrangement for firms that wish to market products and services in the EU and those who focus solely on the UK domestic market".[350]

203. Andrew Bailey, of the FCA, also acknowledged that the Basel standards were designed for global cross-border banking groups, but that "the EU has chosen to implement Basel for all banks and building societies—credit institutions as they call them—irrespective of size, and to implement it in the same way". The argument for flexibility had been put forward by the UK, but Brexit meant that the UK was now less well-placed to exert influence. Nevertheless, Mr Bailey hoped the issue would remain live: "The argument is still there, and, in principle, it would be nice to think that post Brexit we could have the scope for greater flexibility and proportionality."[351]

204. Mr Bailey was keen, however, to differentiate between treating smaller domestic firms differently on the basis of proportionality and a formal dual regime. Under the latter approach, "We have one ring-fenced regime that points towards the EU and operates under EU rules … and the rest of the UK regime would do something different." This would be "quite hard from a prudential point of view, because prudential regulation is whole-firm regulation … You have to be quite careful about those sorts of arguments … They are separate from the point you made about smaller, proportionality-type regimes."[352]

205. Sam Woods also touched on the question of proportionality: "There is a question as to whether the practice we have had historically … of applying all the weight of everything to the smallest firms is sensible", which he felt would in future be a question for both the UK and the EU-27. He continued: "That debate … is not, or should not be, in my view, about weaker standards for smaller companies. It is just a question of whether the full weight of the complexity, all the regulation, needs to apply to the very smallest companies, as well as the biggest ones."[353]

Conclusions and recommendations

206. **Basel rules were meant to apply to large cross-border institutions, and requiring smaller firms to comply with them may be unduly burdensome. Post-Brexit, it would be desirable for regulators to have the ability to apply any regulatory framework in a proportionate manner, where they judge this to be in the interests of consumers and the broader industry. The Government should consult on this once the terms of the UK's access to the EU are agreed.**

FinTech and innovation

207. FinTech is the application of digital technology to the provision of financial services. Developments in this area have the possibility of transforming the financial services sector and the products offered to consumers, radically altering the landscape and operation of the whole industry.

349 Written evidence from the Equity Release Council (FRS0017)
350 Written evidence from ILAG (FRS0014)
351 Q 108
352 Q 108
353 Q 74

208. The UK has been at the forefront of industry and regulatory developments in the FinTech sector, as Deloitte highlighted: "The UK FinTech sector is going from strength to strength. It generated £6.6 billion revenue in 2015 and has a workforce of over 60,000 employees."[354] Neena Gill MEP suggested that this pre-eminence turned in part on London's strength in finance more broadly: "The UK has been at the forefront in the development of the FinTech sector. However the continuation of its leading position will depend on whether London remains a main financial centre."[355] Charlotte Croswell, Chief Executive of Innovate Finance, agreed that the 'ecosystem' was critical, while also noting the strength of global competition: "We have financial services firms with FinTech firms sitting alongside; we have a regulator who has done some very progressive work on this, but we should not forget that it is a global competitive environment for talent."[356]

209. The UK's innovative approaches to FinTech regulation have served as a model for other regulators. In the words of Charlotte Crosswell, the sandbox "has been successfully copied across the world".[357] Funding Circle believed that "the UK approach to regulating direct lending platforms is a blueprint for other European countries to follow. For example, the Spanish and Belgian governments have examined the UK approach and subsequently introduced regulatory regimes for direct lending platforms in their own countries."[358] Catherine McGuinness, Policy Chairman of the City of London Corporation, reflected that she would "highlight the regulatory sandbox as an example of where we are ahead of a lot of the rest of the world and we have something to say very positively".[359]

210. Witnesses highlighted several challenges posed by Brexit. One immediate concern was the probable loss of access to the European Investment Bank (EIB) and the European Investment Fund (EIF). Charlotte Croswell told us: "About 50% of the EIF fund goes to UK companies … so we definitely need a replacement source of funding."[360] Funding Circle noted that in 2016 alone UK small businesses gained £1.2 billion of investment from the EIB.[361]

211. Any loss of EU funding could be partially mitigated by the British Business Bank (BBB). Flora Coleman agreed that "the boosting of public sector funding for these initiatives needs to be maintained and the British Business Bank is the right funnel for that."[362] Charlotte Croswell elaborated: "We can expand British Business Bank resources with capital while reassessing qualifying activities for the EIF … It is something we need to consider quite urgently." [363] Funding Circle noted that the BBB had lent £80 million to more than 15,000 UK small businesses through Funding Circle itself. The BBB was, however, restricted by EU state aid rules that placed limits on the amount it could lend through any one platform.[364] Leaving the EU could allow the Government to remove this constraint, making it easier to support the sector. Charlotte Crosswell also noted that the BBB could be better

354 Written evidence from Deloitte (FRS0016)
355 Written evidence from Neena Gill MEP (FRS0013)
356 Q 91
357 Q 90
358 Written evidence from Funding Circle (FRS0033)
359 Q 28
360 Q 98
361 Written evidence from Funding Circle (FRS0033)
362 Q 98
363 Q 98
364 Written evidence from Funding Circle (FRS0033)

tailored to address regional disparities across the UK: "To have something that also addresses the regional coverage of the British Business Bank is incredibly important, where again we have seen the dominance of London and the south-east."[365]

212. The Minister, Stephen Barclay MP, noted that the Government had awarded an extra £2.5 billion of resources to the BBB as a response to the Patient Capital Review, representing a two-thirds increase in the scale of the Bank. Mr Barclay did not rule out continuing participation in the EIB, and stated that the Government recognised the importance of funding for FinTech: "We are also looking to ensure that either through the EIB or through equivalent funding we maintain what is seen as a key source of finance."[366]

213. As Charlotte Crosswell told us, 40 per cent of FinTech firms are payment firms, meaning that the industry is "international from day one". She therefore believed that the UK should remain part "of the single European payments area. That is available to non-EU firms, but only if we have regulatory convergence." She also noted concerns in the sector "about passporting and Single Market access".[367]

214. Deloitte highlighted the successful 'FinTech bridges' agreed with Australia, China, Singapore and South Korea, enabling the FCA to refer FinTech firms to other regulators and vice versa, and argued: "The UK and EU-27 should consider building a strong 'FinTech bridge' and co-operation agreement with the EU to ensure that, if something similar to passporting rights do not apply after Brexit, barriers to entry into each other's jurisdiction remain as low as possible so that innovation and competition are not stifled."[368]

215. As we noted in our December 2016 report, "The ability to continue to access highly qualified staff and the ability to transfer them between the UK and the EU is a key issue for the finacial services industry."[369] This is a particular challenge for FinTech. As Charlotte Crosswell told us: "There is a skills shortage in the UK, as we look to replace STEM skills through education and university." She explained that 30% of Innovate Finance's members were born overseas, and noted that "in Silicon Valley, 40% of tech workers, taken collectively, are non-US workers". She believed this demonstrated that "entrepreneurs have choice of location; there are roles overseas that they can go to, so we have to continue to make the UK a friendly and easy place to do business so that they continue to want to work here".[370]

216. The Minister acknowledged the importance of access to talent:

> "You are absolutely right that talent is key within the FinTech sector. The Chancellor announced that the Government will be doubling the overall number of tier 1 exceptional talent visas from 1,000 to 2,000 and lifting the tech sector cap within that.[371] The Home Office is also committed to looking at establishing sponsoring bodies outside London,

365 Q 98
366 Q 119
367 Q 91
368 Written evidence from Deloitte (FRS0016)
369 European Union Committee, *Brexit: financial services* (9th Report, Session 2016–17, HL Paper 81) para 81
370 Q 91
371 See European Union Committee, *Brexit: UK-EU movement of people* (14th Report, Session 2016–17, HL Paper 121), Chapter 3 for background on the UK's tiering system.

and the Home Secretary will be inviting the tech community to help to design the system. We in the Government recognise the key importance of talents within the sector and that is why we are taking measures on this."[372]

217. In our inquiry, *Brexit: financial services*,[373] Daniel Morgan, formerly of Innovate Finance, alluded to the fact that the exceptional talent visa had stringent criteria and low awareness. He also stated, with respect to the entrepreneurial visa scheme, that "entrepreneurial talent does not have a definition", and that there were significant barriers to obtaining visas, such as needing "a huge amount of capital already in place behind you", or proving "that you are about to set up a business".[374] The Government's current initiatives may therefore be insufficient to maintain the flow of talent required to sustain UK FinTech.

218. FinTech firms also rely heavily on data. The CBI emphasised that "the UK should also seek close alignment on policy issues that would impact the development of the FinTech industry such as the General Data Protection Regulation (GDPR), which has a material impact on the UK's position as a leading digital economy".[375] This concern was echoed by Deloitte: "If the UK is not permitted to access or retain EU-27 customer personal data under the EU's General Data Protection Regulation (GDPR), this will pose material challenges for firms that currently serve those customers, or hold data in offshore or shared service centres." They argued that the seamless flow of data was particularly crucial for FinTech firms, a large number of which offered "tailored, personalised products" drawn from customer information. Deloitte therefore cautioned that "regulatory barriers to data flow may put UK-based FinTechs at a competitive disadvantage when trying to serve EU-27-based customers".[376]

Conclusions and recommendations

219. **The UK is a world-leader in the field of FinTech. One reason for this is its pioneering approach to regulation of the sector, and the regulators should be commended on initiatives such as the FCA's 'sandbox' and the Bank of England's 'accelerator', which capitalise upon their substantial expertise. Moves by the EU to legislate in this field should be resisted by the Government if they threaten the UK's flexible and adaptive approach.**

220. **We also urge the Government to support the sector's access to capital, given the potential loss of funds from the European Investment Bank. The Government should in particular strengthen the resources of the British Business Bank, not merely to replace the levels of funding offered by the EIB, but to increase UK firms' access to venture capital overall.**

221. **The FinTech industry is reliant on access to skilled labour, as is the wider financial services sector. We call on the Government to consult with the sector in developing its post-Brexit immigration and visa**

372 Q 120
373 European Union Committee, *Brexit: financial services* (9th Report, Session 2016–17, HL Paper 81)
374 Oral evidence taken before the European Union Committee, 2 November 2016 (Session 2016–17) Q 78
375 Written evidence from CBI (FRS0025)
376 Written evidence from Deloitte (FRS0016)

policies, to ensure that the UK's financial services sector, and FinTech in particular, can attract the best global talent.

The future role for UK regulators

222. Building on the UK's innovative strengths will also require the regulators to be equipped with the right mandate and resources. Zurich commented that "neither the PRA nor the FCA has an objective relating to the competitiveness of the UK's financial sector".[377] The ABI wanted this to change post-Brexit, suggesting that "regulators should have a new and explicit remit for UK competitiveness as part of their objectives, in both [a] European and global context".[378] The London Market Group expanded this point, noting that "such a competitiveness duty was previously included within the duties of the Financial Services Authority (FSA), and would require both regulators to have regard to the international competitiveness of the UK's financial services sector in developing their regulatory positions". They believed that "introducing such an objective for the FCA and PRA would also ensure that the UK is better placed to compete with other, growing international insurance hubs where the regulators do have international competitiveness duties, such as Zurich, Bermuda … and Singapore".[379]

223. Barnabas Reynolds told us: "We need to look at whether our regulatory powers or framework should be tuned up again to the new environment by giving them an international competitiveness objective."[380] Julian Adams, while recognising that regulators rightly focus on safety, soundness and consumer protection, agreed:

> "Brexit gives us the opportunity to ensure that we are comfortable with the objectives currently framed for the regulators … The Treasury Select Committee has recognised the argument we made for competition as a primary objective for the PRA, at least for insurance. There is a debate to be had about whether one wants to call it competitiveness, or the promotion of London as a financial centre, that could and should be part of a post-Brexit regulatory landscape."[381]

Mr Adams stressed that this did not necessarily mean weaker regulation: "Competitiveness could be the promotion of the highest possible standards … I do not think it is a question of a race to the bottom, but you can promote London as a centre, and in a post-Brexit world that may be more appropriate and necessary."[382]

224. The Minister, asked whether regulators' remits could be amended, responded that the current regulatory framework had not precluded the UK's ability to remain internationally competitive, mentioning the FCA's sandbox and the UK's work on Islamic finance and green finance. Although he acknowledged that the issue had been raised by the industry, he noted the forthcoming IRSG report on global competitiveness, and indicated his desire not to pre-empt its recommendations.[383]

---

377 Written evidence from Zurich (FRS0042)
378 Written evidence from ABI (FRS0008)
379 Written evidence from London Market Group (LMG) (FRS0020)
380 Q 17
381 Q 85
382 Q 88
383 Q 118

Conclusions and recommendations

225. **As the intensity of international competition facing the UK post-Brexit increases, it may become clear that regulators are unduly constrained by their current objectives. We recommend that the Government consider and consult on the desirability of adding a duty to promote international competitiveness to these objectives. Any change should be accompanied by strengthened Parliamentary scrutiny, given the potential trade-offs inherent in adding such an objective to the remits of the Bank of England and the FCA.**

226. **Whether or not the Government decides to add to the UK regulators' remit, it is important that we engage with all of the pieces of the international regulatory jigsaw. Global competition and global regulatory standards-setting will become yet more crucial after the UK leaves the EU, and the Government should fight to ensure that the international regime for financial services continues to thrive. The Government must not squander the opportunity to enable UK financial services to become more outward-facing and access new markets, and should ensure that the regulators are appropriately equipped to oversee firms operating across borders.**

SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS

The origins of regulation and supervision

1. UK regulators have been highly influential at both technical and political levels within the international standards-setting bodies. The backbone of this engagement is personnel: without the right people in place, the UK will not be able to exercise the same clout. It is important that the UK's financial services industry is reassured that regulators are adequately resourced and supported. The Government should, furthermore, take decisions about key leadership positions as early as practicable. (Paragraph 54)

2. The UK's domestic regime for the regulation of financial services is largely, and increasingly, shaped by the context of international standards and EU law. The UK has been highly influential in shaping the form of supranational regulation, both at the international and EU levels. The UK has also shown leadership in areas of regulation in which it is not constrained by international standards, such as conduct and FinTech; these measures have subsequently served as models for other countries to follow. While leaving the EU may provide opportunities for the UK to tailor its regulation to domestic needs, such opportunities will be necessarily constrained by the UK's continued participation in international fora. (Paragraph 60)

3. It is imperative that the UK continues to devote sufficient resources to engagement with international standards-setters. The Government should continue, as a minimum, to adhere to international standards, and to work vigorously to shape them in future, especially if there is a risk of them being undermined by other states. It is crucial that such standards remain the base of the UK's domestic regime, and that the UK acts to ensure that they are properly implemented worldwide. (Paragraph 61)

4. The Government should also seek to develop new international relationships, to fortify the extant engagement taking place within formal standards-setting bodies and more broadly. This may include considering ways in which further cooperation can be sought within a bilateral context, including setting up joint fora to monitor regulatory developments. Embedding a network of global cooperation via these means could help to synchronise standards within and beyond the EU. (Paragraph 62)

5. Post-crisis changes have served to promote financial stability and the Government should continue to advocate these reforms. This is especially the case if faced with initiatives by the EU that in fact lead to market fragmentation and a reversal of the post-crisis commitments—such as is the case with current proposals that would potentially require CCPs to relocate within the EU. (Paragraph 63)

Incorporating the EU *acquis* in financial services

6. A crucial element of the EU (Withdrawal) Bill process will lie in the resolution of 'inoperables': references to, for example, EU bodies that will no longer have jurisdiction after Brexit. Translating the *acquis* will also require dealing with the agreements the EU has with third countries. These cover areas such as equivalence rulings with non-EU members (for example the agreement with the US under EMIR, which allows EU clearing members to use US CCPs). The UK will need to decide how to incorporate these agreements. UK regulators have also begun to make statements regarding

their proposed treatment of EU businesses within the UK. The clarity that these decisions will ultimately provide is very much to be welcomed. However, insofar as there is a risk to UK financial stability in granting access to third country firms, a new domestic permissions regime must be carefully managed. (Paragraph 77)

7. The Government will need to adopt a nuanced approach towards the translation of EU regulation into domestic law. In future some rules will need to be enshrined in statute, which could be effected using powers contained in the European Union (Withdrawal) Bill. However, it may be more appropriate, where it is important that rules be flexible and dynamic, or where they concern more technical areas, for regulators to issue guidance and set standards. The Government should develop an appropriate architecture for the future domestic regulation of financial services. (Paragraph 89)

8. Any future regulatory regime will probably result in a significant increase in the powers of domestic regulators to determine rules and provide non-statutory, but binding, guidance. It is vital that Brexit, in transferring powers to domestic regulators, should not result in an unintended deficit in democratic scrutiny and accountability. (Paragraph 90)

9. The EU's multi-layered approach to financial regulation is underpinned by detailed and resource-intensive scrutiny by the European Parliament. Assuming that domestic regulators will gain powers as a result of Brexit, the Westminster Parliament will need to increase commensurately the resources available to support a similar level of scrutiny. This is particularly the case with regard to the regulation of financial services, where powers transferred from the EU to UK regulators will require ongoing specialist scrutiny if the UK is to replicate the level of oversight that the European Parliament has to date provided. (Paragraph 91)

10. We note that this issue concerns both Houses; we also note the forthcoming review of the Committee structure of the House of Lords, which is being conducted by the House of Lords Liaison Committee. In light of these factors, we do not seek to make specific recommendations on future parliamentary scrutiny. It is clear, however, that financial services will require increased scrutiny and resources in relation to domestic, EU and international level regulatory standards, and that the burden will necessarily fall upon Parliament. We look forward to the House of Lords Liaison Committee addressing this issue in the course of its review. (Paragraph 92)

Possibilities for a transition period

11. Transition should in the first instance provide a standstill extension of the current conditions of market access: this appears to be envisaged by both the Commission and the Government. To be useful, however, any period of transition needs to form part of a three-stage process. First, a standstill period, allowing time for the two sides to agree the terms of their future relationship; then, once that relationship (the ultimate destination) is known, a period of adaptation; and, finally, the seamless commencement of trade under the terms of the new relationship. Absent all these elements of transition, financial services firms will be forced to activate their worst-case scenario contingency plans, with stark implications for the continued provision of services and for financial stability. (Paragraph 102)

12. We welcome the announcement by the European Council that the first priority for negotiations in 2018 will be agreement on transition. Such an agreement needs to be announced soon for it to prevent the enactment of the financial services industry's contingency plans, with the disruption and uncertainty that would cause for counterparties in both the UK and the EU-27. (Paragraph 119)

13. We note the views of those in the financial services sector who seek a legally binding transition agreement in Q1 2018. Whether or not this is feasible, any such agreement will need to be at least politically binding if it is to provide reassurance to firms that there will be no cliff-edge in 2019. Due to the central position of the UK's financial services sector within the EU's financial services industry, and the number of EU-27 clients that rely on accessing this market, it is in the interests of both the UK and the EU that such an agreement is in place, in order to prevent large-scale risks to financial stability. (Paragraph 120)

14. It will be essential, either alongside or as part of a transition agreement, to provide clarity on issues of contractual continuity. Insurance contracts will need to be 'grandfathered'—treated according to current terms—for their duration. It may be possible for other contractual issues, such as the servicing of derivatives contracts, to be provided for within the time-limited confines of a transition period, but such a period cannot be expected to solve all issues. It is imperative therefore that continuity of contracts is treated and resolved comprehensively. (Paragraph 121)

Alignment and market access

15. The EU's equivalence regime is patchy in composition, and too politically insecure for firms to feel confident in making use of its provisions. It would not allow the highly integrated web of financial services within the EU to persist in anything like its current form. Equivalence provisions are currently undergoing a review; depending on how equivalence is in future interpreted, there is a serious risk that it may leave the UK a rule-taker. And if the UK is no longer able to influence the composition of EU laws, these rules could increasingly become unsuited to the UK financial services sector, which is the largest provider of such services in the EU. (Paragraph 135)

16. There are various legal means by which to facilitate mutual access. Equivalence, as currently framed under EU law, would not be sufficient, but could, with political will, potentially provide a basis for negotiating a more comprehensive agreement in the form of an 'enhanced equivalence' regime. A free trade agreement, or a separate bilateral agreement on mutual market access, would achieve a similar result. (Paragraph 149)

17. An agreement granting secure, symmetric access would be to the mutual economic advantage of both the UK and the EU, but significant political hurdles remain. The Government, in approaching the next phase of negotiations with the EU, must work to foster the goodwill and understanding necessary to achieve this goal. (Paragraph 150)

18. We conclude that the current equivalence regime would fail to provide the level of market access for financial services that both sides require, and that it would inhibit the UK from developing an appropriate regulatory framework. The Government should not settle for an agreement based on equivalence without securing substantial changes to that regime. (Paragraph 157)

19. There are various possibilities for a future agreement covering financial services. These include a free trade agreement to include services, a standalone mutual recognition regime, and possibly some form of so-called ‘enhanced equivalence’. We do not come to a view on which of these would be preferable, although all would be more satisfactory than equivalence. However, it has to be acknowledged that free trade agreements take time, sometimes years, to agree, and there is no precedent for an agreement on the scale that the Government seeks. (Paragraph 158)

20. Whichever option is pursued, it will be vital to put in place a robust dispute resolution mechanism, which is as yet undetermined. This may require new institutions to arbitrate such matters, or involve existing courts. The Government should make clear which arrangements it favours, given its well-publicised red line on the jurisdiction of the Court of Justice of the European Union. (Paragraph 159)

21. We recognise that the EU, or individual Member States, may be politically motivated to reject a bespoke agreement regarding future access. However, such an agreement would be in the overriding economic interest of all sides. Without it, EU counterparties stand to lose the substantial benefits that come from being able to draw on the services offered by the UK. The EU has in the past shown ambition and imagination in seeking to include financial services in the TTIP free trade negotiations. We urge all sides to show similar imagination in negotiating the future UK-EU partnership. (Paragraph 160)

Supervisory cooperation

22. The Commission’s proposed revisions to EMIR contain both good and bad elements. Giving ESMA additional powers of oversight will help reassure financial market participants, especially to the extent that this will involve cooperation with the NCAs. However, proposals to demand the relocation of systemic CCPs within the eurozone will not achieve the Commission’s objectives of bolstering financial stability. They will instead increase costs to market participants, particularly those inside the EU-27; cause fragmentation, by reversing G20 measures taken to contain risk within CCPs; and result in the loss of clearing business for both the UK and EU-27, as clearing members move their positions to New York. The Government should resist these measures by whatever means possible. (Paragraph 186)

23. The existence of supervisory colleges, and the relationships between third-country NCAs and ESMA, could serve as a template for future supervision of financial market infrastructures. To the extent that such supervisory cooperation promotes financial stability, as would be the case with the proposals to revise EMIR, it may also obviate the need to relocate those infrastructures within the EU. Further measures to enhance such cooperation within the European legislative structure should therefore be encouraged, although proposals to centralise authority in ESMA will need to be carefully scrutinised. (Paragraph 187)

24. The evidence we heard consistently highlighted the strength and depth of existing supervisory cooperation and the extent of the EU’s reliance on the UK’s contribution. While the UK’s technical expertise is an asset for the EU, the Government should not treat this as a guarantee that the UK will be able to continue to contribute to the decision-making process. We therefore urge the Government to seek to secure continued participation for UK regulators at all levels of the supervisory architecture post-Brexit, to

be imaginative in developing new forms of cooperation, and to continue to invest in international and bilateral relationships. (Paragraph 188)

Regulatory innovation, FinTech and the future

25. While there might be reason to change some aspects of Solvency II, the benefits of flexibility will in all cases need to be balanced against the possible consequences of regulatory divergence. The key issue raised in evidence to this inquiry was the risk margin. The Government and regulators should consider whether Solvency II requirements need to be updated in order to reflect the specificities of the UK insurance market, within the bounds of whatever agreement is reached with the EU on future market access. (Paragraph 200)

26. Basel rules were meant to apply to large cross-border institutions, and requiring smaller firms to comply with them may be unduly burdensome. Post-Brexit, it would be desirable for regulators to have the ability to apply any regulatory framework in a proportionate manner, where they judge this to be in the interests of consumers and the broader industry. The Government should consult on this once the terms of the UK's access to the EU are agreed. (Paragraph 206)

27. The UK is a world-leader in the field of FinTech. One reason for this is its pioneering approach to regulation of the sector, and the regulators should be commended on initiatives such as the FCA's 'sandbox' and the Bank of England's 'accelerator', which capitalise upon their substantial expertise. Moves by the EU to legislate in this field should be resisted by the Government if they threaten the UK's flexible and adaptive approach. (Paragraph 219)

28. We also urge the Government to support the sector's access to capital, given the potential loss of funds from the European Investment Bank. The Government should in particular strengthen the resources of the British Business Bank, not merely to replace the levels of funding offered by the EIB, but to increase UK firms' access to venture capital overall. (Paragraph 220)

29. The FinTech industry is reliant on access to skilled labour, as is the wider financial services sector. We call on the Government to consult with the sector in developing its post-Brexit immigration and visa policies, to ensure that the UK's financial services sector, and FinTech in particular, can attract the best global talent. (Paragraph 221)

30. As the intensity of international competition facing the UK post-Brexit increases, it may become clear that regulators are unduly constrained by their current objectives. We recommend that the Government consider and consult on the desirability of adding a duty to promote international competitiveness to these objectives. Any change should be accompanied by strengthened Parliamentary scrutiny, given the potential trade-offs inherent in adding such an objective to the remits of the Bank of England and the FCA. (Paragraph 225)

31. Whether or not the Government decides to add to the UK regulators' remit, it is important that we engage with all of the pieces of the international regulatory jigsaw. Global competition and global regulatory standards-setting will become yet more crucial after the UK leaves the EU, and the Government

should fight to ensure that the international regime for financial services continues to thrive. The Government must not squander the opportunity to enable UK financial services to become more outward-facing and access new markets, and should ensure that the regulators are appropriately equipped to oversee firms operating across borders. (Paragraph 226)

APPENDIX 1: LIST OF MEMBERS AND DECLARATIONS OF INTEREST

Members

Lord Bruce of Bennachie
Lord Butler of Brockwell
Lord De Mauley
Lord Desai
Baroness Falkner of Margravine (Chairman)
Lord Fraser of Corriegarth
Lord Haskins
Baroness Liddell of Coatdyke
The Earl of Lindsay
Baroness Neville-Rolfe
Lord Skidelsky
Lord Woolmer of Leeds

Declarations of interest

Lord Bruce of Bennachie

A small shareholding in Royal Bank of Scotland which is below the threshold for registration in the House of Lords Register of Interests

Lord Butler of Brockwell

Adviser to TT International

Lord De Mauley

Investment, in respect of which the vast majority are made at the direction of an independent fund manager, in unit trusts, investment trusts, limited companies, EIS and VCT instruments etc.

An investment in Foresight VCT plc

An investment in the St. James's Place International Bond Fund

Farmer, in receipt of CAP support

Lord Desai

No relevant interests declared

Baroness Falkner of Margravine (Chairman)

A small number of shareholdings in financial services companies which are below the threshold for registration in the House of Lords Register of Interests

Lord Fraser of Corriegarth

Shareholdings in: Aviva plc, Beazley plc, HSBC Holdings plc, JP Morgan Chase & Co, Lloyds Banking Group, Polar Capital Holdings plc, Prudential plc, Standard Life Investments Ltd

Lord Haskins

Chairman, Humber Local Enterprise Partnership (LEP)

Director, JSR Farms Ltd

Director, Quarryside Farms Ltd

Shareholdings in: Lloyds Banking Group, Mitsubishi UFJ, Mizuho Financial Group, Sumitomo Mitsui Financial, T&D

A small number of shareholdings in financial services companies which are below the threshold for registration in the House of Lords Register of Interests

Baroness Liddell of Coatdyke

Association member of BUPA

Member, Advisory Board, Price Waterhouse Coopers

A small number of shareholdings in financial services companies which are below the threshold for registration in the House of Lords Register of Interests

The Earl of Lindsay

A shareholding in Prudential plc

A small number of shareholdings in financial services companies which are below the threshold for registration in the House of Lords Register of Interests

Baroness Neville-Rolfe

Former Commercial Secretary to the Treasury (left June 2017)

A small number of shareholdings in financial services companies which are below the threshold for registration in the House of Lords Register of Interests

Lord Skidelsky

A shareholding in Janus Capital Group

Lord Woolmer of Leeds

A small number of shareholdings in financial services companies which are below the threshold for registration in the House of Lords Register of Interests

The following Members of the European Union Select Committee attended the meeting at which the report was approved:

Baroness Armstrong of Hill Top
Lord Boswell of Aynho (Chairman)
Baroness Brown of Cambridge
Baroness Browning
Baroness Falkner of Margravine
Lord Jay of Ewelme
The Earl of Kinnoull
Lord Liddle
Baroness Neville-Rolfe
Lord Selkirk of Douglas
Baroness Suttie
Lord Teverson
Baroness Verma
Lord Whitty
Baroness Wilcox

During consideration of the report the following Members declared an interest:

Lord Boswell of Aynho

A small number of shareholdings in financial services companies which are below the threshold for registration in the House of Lords Register of Interests

List of shareholdings as detailed in the House of Lords Register of Interests

Baroness Brown of Cambridge

Former Non-executive Director of Green Investment Bank

A small shareholding in Lloyds Banking Group which is below the threshold for registration in the House of Lords Register of Interests

Lord Selkirk of Douglas

Diversified investment portfolio in McInroy & Wood Income Fund managed by third parties

An interest in a small family company as Director and Chairman, with a specific interest in one or two wind turbines and areas of land

House of Commons pension, Scottish Parliament pension and state pension

A full list of Member's interests can be found in the Register of Lords Interests:

http://www.parliament.uk/mps-lords-and-offices/standards-and-interests/register-of-lords-interests/

APPENDIX 2: LIST OF WITNESSES

Evidence is published online at: https://www.parliament.uk/financial-regulation-supervision-inquiry-lords and available for inspection at the Parliamentary Archives (020 7219 3074).

Evidence received by the Committee is listed below in chronological order of oral evidence and in alphabetical order. Those witnesses marked with ** gave both oral evidence and written evidence. Those marked with * gave oral evidence and did not submit any written evidence. All other witnesses submitted written evidence only.

Oral evidence in chronological order

*	Professor Eilís Ferran, Professor of Company and Securities Law, University of Cambridge	QQ 1–9
*	Professor Niamh Moloney, Professor of Law, London School of Economics and Political Science	QQ 1–9
**	Simon Gleeson, Financial Services, Clifford Chance	QQ 10–18
	Jonathan Herbst, Global Head of Financial Services, Norton Rose Fulbright	QQ 10–18
*	Barnabas Reynolds, Head of Financial Institutions Advisory and Financial Regulatory Group, Shearman & Sterling LLP	QQ 10–18
*	Catherine McGuinness, City of London Corporation	QQ 19–30
*	Mark Hoban, Chairman, Flood Re and Chairman, International Regulatory Strategy Group (IRSG)	QQ 19–30
*	Rachel Kent, Partner, Head of Financial Institutions Group, Hogan Lovells	QQ 19–30
**	Simon Lewis, Association for Financial Markets in Europe (AFME)	QQ 31–45
**	Stephen Jones, Chief Executive Officer, UK Finance	QQ 31–45
*	Daniel Maguire, Chief Executive Officer, London Clearing House	QQ 46–63
*	Simon Puleston Jones, Head of Europe, Futures Industry Association (FIA)	QQ 46–63
*	Sir Jon Cunliffe, Deputy Governor for Financial Stability, Bank of England	QQ 64–78
*	Sam Woods, Deputy Governor for Prudential Regulation and Chief Executive Officer of the Prudential Regulation Authority (PRA)	QQ 64–78
**	Julian Adams, Group Regulatory Director, Prudential	QQ 79–89
*	Sally Dewar, International Head of Regulatory Affairs, JP Morgan	QQ 79–89
*	Flora Coleman, Head of Government Relations, TransferWise	QQ 90–98

*	Charlotte Crosswell, Chief Executive Officer, Innovate Finance	QQ 90–98
*	Andrew Bailey, Chief Executive Officer, Financial Conduct Authority (FCA)	QQ 99–108
*	John McFarlane, Chairman, Barclays	QQ 109–115
*	Steven Barclay MP, Economic Secretary to the Treasury, HM Treasury	QQ 116–124
*	Lowri Khan, Director, Financial Stability, HM Treasury	QQ 116–124
*	Richard Knox, Director, Financial Services (International), HM Treasury	QQ 116–124
*	Karel Lannoo, Chief Executive Officer, Centre for European Policy Studies (CEPS)	QQ 125–134
*	Dr Kay Swinburne MEP, Vice Chairman of Economic and Monetary Affairs Committee, European Parliament	QQ 135–147

Alphabetical list of all witnesses

**	Julian Adams, Group Regulatory Director, Prudential (QQ 79–89)	FRS0037
	Alistair Milne, Loughborough University	FRS0035
	Association of British Insurers (ABI)	FRS008
	Aviva	FRS0032
*	Andrew Bailey, Chief Executive Officer, Financial Conduct Authority (FCA) (QQ 99–108)	
	Barclays	FRS0040
*	Stephen Barclay, Economic Secretary to the Treasury, HM Treasury (QQ 116–124)	
	Mr Graham Bishop	FRS0001
	Building Societies Association	FRS0010
	Bupa	FRS0038
*	Flora Coleman, Head of Government Relations, TransferWise (QQ 90–98)	
	CLS Group	FRS0018
	Confederation of British Industry (CBI)	FRS0025
	Coventry Building Society	FRS0030
*	Charlotte Crosswell, Chief Executive Officer, Innovate Finance (QQ 90–98)	
*	Sir Jon Cunliffe, Deputy Governor for Financial Stability, Bank of England (QQ 64–78)	
	Deloitte	FRS0016

*	Sally Dewar, International Head of Regulatory Affairs, JP Morgan (QQ 79–89)	
	Envestnet Yodlee	FRS0050
	Equity Release Council	FRS0017
*	Professor Eilís Ferran, Professor of Company and Securities Law, University of Cambridge (QQ 1–9)	
	Financial Services Consumer Panel	FRS0024
	Fitch Ratings Ltd	FRS0022
	Funding Circle	FRS0033
	Neena Gill MEP	FRS0013
**	Simon Gleeson, Financial Services, Clifford Chance (QQ 10–18)	FRS0039
	HM Government of Gibraltar	FRS0015
*	Jonathan Herbst, Global Head of Financial Services, Norton Rose Fulbright (QQ 10–18)	
*	Mark Hoban, Chairman, Flood Re and Chairman, International Regulatory Strategy Group (IRSG) (QQ 19–30)	
	Institute of Chartered Accountants in England and Wales (ICAEW)	FRS0046
	Institute and Faculty of Actuaries	FRS0031
	Investment & Life Insurance Group	FRS0014
	Investment Association	FRS0029
**	Stephen Jones, Chief Executive Officer, UK Finance (QQ 31–45)	FRS0044
*	Rachel Kent, Partner, Head of Financial Institutions Group, Hogan Lovells (QQ 19–30)	
*	Lowri Khan, Director, Financial Stability, HM Treasury (QQ 116–124)	
	Killick & Co	FRS0005
*	Richard Knox, Director, Financial Services (International), HM Treasury (QQ 116–124)	
	KPMG	FRS0043
*	Karel Lannoo, Chief Executive Officer, Centre for Policy Studies (CEPS) (QQ 125–134)	
	Law Society of Scotland	FRS0026
**	Simon Lewis, Association for Financial Markets in Europe (AFME) (QQ 31–45)	FRS0021 FRS0049
	Lloyd's and the Lloyd's Market Association (LMA)	FRS0028
	Loan Market Association	FRS0002

	London and International Insurance Brokers' Association	FRS0006
	London Market Group (LMG)	FRS0020
	London Metal Exchange (LME)	FRS0048
	London Stock Exchange Group (LSEG)	FRS0047
*	Daniel Maguire, Chief Executive Officer, London Clearing House (QQ 46–63)	
	Mastercard	FRS0036
**	John McFarlane, Chairman, Barclays (QQ 109–115)	FRS0040
*	Catherine McGuinness, City of London Corporation (QQ 19–30)	
*	Professor Niamh Moloney, Professor of Law, London School of Economics and Political Science (QQ 1–9)	
	Personal Investment Management and Financial Advice Association (PIMFA)	FRS0009
	PricewaterhouseCoopers (PwC)	FRS0019
*	Simon Puleston Jones, Head of Europe, Futures Industry Association (FIA) (QQ 46–63)	
*	Barnabas Reynolds, Head of Financial Institutions Advisory and Financial Regulatory Group, Shearman & Sterling LLP (QQ 10–18)	
	Pierre Schammo, University of Durham School of Law	FRS0004
	States of Guernsey	FRS0027
*	Dr Kay Swinburne MEP, Vice Chairman of Economic and Monetary Affairs Committee, European Parliament (QQ 135–147)	
	TheCityUK	FRS0041
*	Sam Woods, Deputy Governor for Prudential Regulation and Chief Executive Officer of the Prudential Regulation Authority (PRA) (QQ 64–78)	
	Which?	FRS0045
	Zurich Insurance	FRS0042

APPENDIX 3: CALL FOR EVIDENCE

The House of Lords EU Financial Affairs Sub-Committee, chaired by Baroness Falkner of Margravine, has launched an inquiry into the future of financial regulation and supervision following Brexit. The Committee invites interested individuals and organisations to submit evidence to this inquiry.

Written evidence is sought by 29 September 2017. Public hearings are expected to begin in September. The Committee aims to report to the House, with recommendations, in late 2017 or early 2018. The report will receive a response from the Government, and may be debated in the House.

Background

The UK is currently subject to over 40 pieces of EU primary legislation on financial services, together with innumerable pieces of technical ('level 2') legislation shaped by the European Supervisory Agencies (ESAs). After Brexit, the UK will in principle be free to make its own choices on how to regulate, and supervise, the domestic financial services industry. Nonetheless, the extent of the current relationship between the two jurisdictions is considerable, with the UK's financial services industry providing a significant proportion of the financing and market infrastructure available to the EU. The depth of the interdependence between the UK and EU entails that there is likely to be some form of ongoing cooperation, in the interests of maintaining access, adequately aligned regulation, and financial stability. This may in turn restrict the UK's room for regulatory manoeuvre or innovation–either during a temporary period of transition, or more permanently.

If the UK wishes to seek regulatory equivalence (or a similar, potentially enhanced, arrangement) with the EU, it will be necessary in certain areas to stay in lockstep and to continue to cooperate with the European Supervisory Agencies. Furthermore, the UK's current regulatory framework is shaped not only by the EU, but also the international level (in the form of standards set by the Financial Stability Board and the Basel Committee on Banking Standards). The extent to which the UK might wish to engage the newfound potential for autonomy is not yet clear, or indeed whether it would wish to do so in order to lessen or enhance the scope of existing regulation.

The EU regulatory regime is also not a static target. Continued efforts to adapt the scope of regulation are likely to affect the UK as a third country. Current proposals may result, for example, in increases to the powers of the ECB and ESMA in respect of euro-denominated clearing, to allow for shared supervision and the potential relocation of 'systemically important' clearing activity to the EU. The current review of the ESAs may redraw the landscape of EU supervision entirely, and the future of the equivalence framework (together with the legislation that underpins it) is in the EU's gift. Any divergence between the EU and UK regimes in future may therefore arise from future adaptation by the EU, as well as by the UK.

Given the uncertain context, it is important to gain a clear picture of the UK's current regulatory regime, with a view to understanding how EU rules will be embedded via the European Union (Withdrawal) Bill, and whether any changes may be made to the status quo in the near term. Questions also remain over how the UK's supervisors will work with their EU counterparts in the future, and how the newly domesticated regime will be managed, not least with respect to the potential emergence of cross-border banking crises and the supervision of market infrastructure.

The Committee will examine how financial regulation and supervision can evolve following Brexit in order to ensure financial stability. This may involve maintaining equivalence or some other form of close relationship between the UK and EU regulatory regimes (thus preserving market access for UK-based firms). The inquiry will encompass an assessment of not only the body of regulation, but also the institutional structures that support it. The Committee will consider in particular the following areas:

- The scope for the UK to adapt its own regime to new circumstances post-Brexit and foster innovation, while still maintaining market access;
- Whether equivalence is the best means to achieve continued cooperation, and what other forms of alignment could exist;
- Differences between the UK, EU and international regimes in financial regulation and where gaps exist;
- Whether there are areas in which it could be beneficial for the UK to deviate from the EU's current framework in future;
- How any regulatory divergence, and shared supervisory concerns, can best be managed, including mechanisms for dispute resolution.

Issues

The Committee seeks evidence on the following questions in particular:

Current regulatory regimes

(1) What is your overall assessment of the EU's financial services regime, in light of its current application to the UK? To what extent is it effective, and for whom?

(2) Are current EU proposals on banking and financial services in your view positive for financial stability? How do you expect the EU's regulatory framework to evolve in the coming years?

(3) What are the key differences between financial regulation as agreed at the international, EU and UK levels, and where are the gaps? How important is it to maintain a level playing field for regulation?

(4) Are there any particular legal or practical challenges related to incorporating the existing body of EU financial services legislation into the UK's domestic law, for example the PRA rulebook?

Transition, equivalence and alignment

(5) What would be the key priorities for a transitional arrangement, and how much continuity would you expect to see under such an arrangement?

(6) In practical terms, how and when could a transitional arrangement be agreed and put in place? How long would such a transition need to last?

(7) What are the benefits and drawbacks of seeking equivalence? What conditions are likely to be attached by the EU to any equivalence decisions?

(8) What alternatives may exist for maintaining alignment between the UK's and EU's regimes? What options could be considered for resolving disputes or arbitrating on such matters? What would be the barriers to a more bespoke arrangement?

The future environment

(9) What effect will the loss of the UK have on the development of the EU financial services framework and its capital markets?

(10) Where is there scope for the UK to amend its regulatory regime? What precedents exist under current equivalence decisions for divergence to occur?

(11) What challenges will expected innovations in financial markets, for instance in the FinTech sector, present in respect of regulation and supervision post-Brexit? How can these challenges be overcome? Can the UK maintain a competitive advantage while adapting to a new regime? If so, how?

(12) Will leaving the EU affect the way that the UK represents itself in international fora? How can the UK continue to maintain influence when dealing with organisations such as the FSB and IOSCO in setting international standards?

Supervision

(13) The Commission is currently conducting a review of the European Supervisory Agencies. What, in your view, are the key areas where reform should be pursued and what might be the impact of such reform on UK supervision?

(14) How could an enhanced role for ESMA and the ECB in respect of euro-denominated clearing work? What are the options for the UK to retain euro clearing in the light of the European Commission's recent proposals?

(15) How would supervisory cooperation (as envisaged for CCPs) work in practice? Are there any precedents? What are the potential risks?

You need not address all of these questions.

24 July 2017

APPENDIX 4: CORRESPONDENCE WITH THE CHANCELLOR ON TRANSITION

Letter from the Chairman to the Rt Hon Philip Hammond MP, Chancellor of the Exchequer, 8 November 2017

The EU Financial Affairs Sub-Committee is currently conducting an inquiry into the future of financial regulation and supervision following Brexit, with a view to producing a full report in early 2018. Nonetheless, we wanted to write to you ahead of this schedule to highlight the evidence we have received on the urgent need for an agreement on a standstill transition period as a priority for the UK Government in the negotiations.

Our evidence has been emphatic that, for the financial services industry to be able to continue the orderly servicing of cross-border clients, a transition period needs to be agreed by the end of the year. A transition period is a 'wasting asset', and banks and insurers will begin to put into effect contingency arrangements, in anticipation of market access being suspended in March 2019, in Q1 2018. The Secretary of State for Exiting the European Union, the Rt Hon David Davis MP, told the EU Select Committee on 31 October that "We would like an implementation agreement in the first quarter of next year—that being the earliest we could possibly get it—in principle". Our evidence, however, suggests that leaving an agreement this late would result in a significant number of relocation plans being put in motion.

One critical aspect identified by our interlocutors is the issue of contractual continuity. Our evidence, from both industry and from the Bank of England, has indicated concern over the scale of novations that would be necessary in the absence of a reciprocal agreement to grandfather existing contracts. These concerns extend, inter alia, to insurance and derivatives contracts, if an agreement on contractual certainty is not reached.

Our witnesses are concerned that they cannot rely on a mere statement of intent; some witnesses said that such an agreement would need to be legally binding in order to be seen as trustworthy. How do you foresee a transition agreement being promulgated in order that UK and EU businesses can rely on it for the purposes of their business planning, regardless of the subsequent outcome of negotiations?

In light of the urgency of the topic, we have concluded that we should bring this part of our evidence to your attention and will welcome your speedy response.

Letter from the Rt Hon Philip Hammond MP, Chancellor of the Exchequer, to the Chairman, 2 December 2017

Thank you for your letter of 8 November concerning financial regulation and supervision following the UK's withdrawal from the European Union. The government agrees with the Committee on the importance of minimising any risks of disruption as the UK withdraws from the EU, and maintaining the ability of the financial services industry to continue the orderly service of cross-border clients.

The government has been actively engaging with the UK regulators and with the financial services sector to understand how the UK's withdrawal from the European Union could impact financial services firms and their customers. As your letter notes, a key concern is the potential impact of the UK's withdrawal on cross-border financial services contracts in force at the point of exit.

As the Financial Policy Committee explained in its November Financial Stability Report, a withdrawal of permissions to conduct cross-border business following the UK's withdrawal from the European Union could impair financial companies' ability to perform or service outstanding financial contracts. This could affect both UK and EU27 financial services firms and their customers. The Financial Policy Committee judges that the largest identified risks relate to over-the-counter derivatives and insurance contracts. The government is considering all options for mitigating these risks.

The government is clear that an integral part of delivering our withdrawal will be the negotiation of a time-limited implementation period, to provide certainty and avoid a cliff-edge for business and individuals during the adjustment from the current structures of membership to the new relationship. The Secretary of State for Exiting the European Union has said recently that he believes an implementation period can be agreed very early next year, and that it is in the interests of both the UK and the EU27 to do so. An implementation period would mean that companies will only have to prepare for one set of changes, and also means businesses in both the UK and the EU27 avoid having to take any decisions before they know the shape of the final deal.

As the Prime Minister said in her speech in Florence, the framework for this time-limited implementation period can be agreed under Article 50. Furthermore, the Withdrawal Agreement and Implementation Bill will be introduced after the Withdrawal Agreement has been reached between the EU27 and UK. The Withdrawal Agreement and Implementation bill will contain the necessary powers to legislate for the implementation period.

APPENDIX 5: THE IMPACT OF BREXIT ON THE FINANCIAL SERVICES SECTOR

The effect of leaving the EU on the financial services industry

1. Our previous inquiry into financial services, *Brexit: financial services*,[384] considered the anticipated effects of withdrawal on the UK industry. The present inquiry has focused more narrowly on the regulatory and supervisory implications of withdrawal, but we have also received significant evidence from the financial services industry on the anticipated impact of Brexit more broadly. In particular, the industry is concerned about the cliff-edge withdrawal of the pan-EU 'passport', which underpins cross-border business within the Single Market.

2. The effects of Brexit will not be felt uniformly across the financial services industry. As Simon Lewis, Chief Executive of AFME, told us, there are "three broad business models: there are banks that have London as a hub from which they have been used to passporting their activities to the EU-27, and clearly for those banks there will be potentially quite significant structural and legal changes. There are those of our members who have a pan-European structure, who therefore should be able to deal with the effects of Brexit a little more easily. Then there are banks that are heavily concentrated locally in one market."[385] This appendix therefore briefly outlines the scope of the sectoral evidence we received on how Brexit will affect different parts of the industry.

Wholesale banks

3. The wholesale banking sector is perhaps the poster child for the impact of Brexit on financial services, due to its status as an issuer of cross-border loans under the CRD passport. The Loan Market Association identified "a risk in some jurisdictions that where the lender or loan owner is a UK passported bank, if that entity ceases to be passported whilst the loan is still outstanding, the loan itself may be legally vulnerable. Such legal uncertainty creates the potential for legal disputes." In consequence, "UK-based lenders would begin as part of their Brexit implementation planning to work on the basis that they will not be able to meet obligations under some existing loan business". As a result, "Many UK-based banks and investment firms have established branches in the EU27 using their passport rights under CRD and MiFID."[386]

Retail banks

4. Exclusive providers of domestic retail financial services are generally less affected by Brexit. The EU's regulatory regime has increasingly begun to cover the provision of retail financial services, but still leaves the majority of retail banking regulation, together with conduct issues, to domestic regulators. Clifford Chance argued that in consequence, any future agreement "might not extend to retail business", as "National retail markets have distinctive national characteristics and, as a result, distinctive national regulations."[387] The Personal Investment Management and Financial Advice Association

384 European Union Committee, Brexit: financial services (9th Report, Session 2016–17, HL Paper 81)
385 Q 42
386 Written evidence from the Loan Market Association (FRS0002)
387 Written evidence from Clifford Chance (FRS0039)

(PIMFA) did not, therefore, "believe that a Single Market for retail financial services products has been created".[388]

5. Which?, the consumer organisation, noted however that EU initiatives on retail financial services have included: the right of access to basic bank accounts; deposit protection in the event of bank failure; development of an integrated payment services market; promotion of cross-border distribution and consumer protection for insurance, mortgages, and other consumer credit; and requirements for the disclosure of key information and charges for retail investment products (the Key Information Documents required under the PRIIPS regime). Which? were generally positive about the nature of the EU's regime on retail financial products, and argued that the UK should largely maintain the existing regulatory framework.[389]

Asset management

6. The asset management industry is generally less materially affected by the need to relocate in light of Brexit, insofar as the EU's current legislative framework permits third-country involvement. This may change in future: the sector is directly affected by specific EU laws such as MiFID II (which is only finally coming into effect in 2018) and the AIFMD (which is slated for review during 2018).

7. Deeper concerns lay with the continued ability to use delegation (which allows an asset manager to set up a fund in one country and outsource portfolio management to investment staff in another country).[390] Delegation, the Investment Association explained, "is not derived from an EU passport. Rather, it is an international convention frequently used to offer, among other services, investment management expertise, and is a key enabler for efficient global capital markets." They argued that "The UK's departure from the EU is, however, raising important concerns within EU-27 Member States about the increased amount of portfolio management activity that will be carried out on behalf of EU clients post-Brexit".[391] They also observed that the EU was considering giving further powers to the European Securities and Markets Authority (ESMA) to monitor delegation.

Insurance

8. Bupa commented that "The insurance industry in the EU is globally successful, as evidenced by the fact that the majority of globally systemically important insurers (G-SIIs) are headquartered in Europe".[392] Furthermore, as the London and International Insurance Brokers' Association (LIIBA) observed, the UK insurance market provides a range of specialist insurance and reinsurance services that are unique in the EU.[393] Market access is a controversial issue for insurers: for large cross-border providers such as Lloyd's, losing access to the EU Single Market would be detrimental,[394] whereas institutions such as the Equity Release Council were more sanguine, asserting that "there is valid reason to question the size and (crucially) the

388 Written evidence from PIMFA (FRS0009)
389 Written evidence from Which? (FRS0045)
390 George Parker, Peter Smith, and David Keohane, 'Britain braced for Brexit raid on £8tn asset management industry', *Financial Times* (3 January 2018): https://www.ft.com/content/d2cde5e6-f095-11e7-b220-857e26d1aca4 [accessed 18 January 2018]
391 Written evidence from the Investment Association (FRS0029)
392 Written evidence from Bupa (FRS0038)
393 Written evidence from LIIBA (FRS0006)
394 Written evidence from Lloyd's and the Lloyd's Market Association (FRS0028)

profitability of the cross-border market for insurance".[395] Aviva noted that insurance differed from, for example, wholesale banking, in that "some of the firms that operate in a number of different EU markets tend to do so through separately capitalised subsidiaries".[396]

9. Insurers are covered by two EU regimes: the incoming Insurance Distribution Directive,[397] which as LIIBA noted, currently contains no concept of equivalence, and Solvency II, which contains provisions that were criticised by many witnesses as inappropriate for the UK market. Insurance may, therefore, be an area in which the UK would seek to make regulatory changes post-Brexit (see Chapter 7).

FinTech

10. FinTech—the incorporation of technology in financial services provision—generally makes less use of passporting than other sectors of the industry, but the small size of many firms, and their close relationships with other, larger firms, means that withdrawal may still be disruptive. Funding Circle told us that although they did "not benefit from EU passporting, we work closely with a number of financial institutions (for example, as participants on our direct lending platform or that provide services to us) that rely heavily on passporting". There would be a "clear business and relationship disadvantage if those institutions felt compelled to move all or a substantial portion of their operations out of the UK".[398]

11. The London Stock Exchange Group (LSEG) raised further concerns regarding access to "data, services, capital and talent".[399] Funding Circle also focused on capital, arguing that withdrawal from the European Investment Bank (EIB) "would have the adverse effect of preventing thousands of small businesses from accessing large amounts of capital from an institution that has provided substantial support to our economy over the years".[400]

Central Counterparties (CCPs)

12. Central counterparties—clearing houses—are a vital part of the global financial market infrastructure, and a large amount of this business is currently concentrated, for reasons of efficiency, in London. CCPs interpose themselves between counterparties to a trade, becoming buyer to every seller and seller to every buyer, thus reducing costs through netting, and concentrating counterparty risk in a single institution that can be supervised accordingly.

13. Perhaps the most salient concern for UK CCPs and their clearing members is the Commission's current proposal to revise the European Market Infrastructure Regulation (EMIR). As well as effecting positive changes to the clearing obligation in order to introduce more proportionality, the proposed revisions would increase oversight of third-country CCPs (a move made directly as a result of Brexit), with the potential to force them to seek

395 Written evidence from the Equity Release Council (FRS0017)
396 Written evidence from Aviva (FRS0032)
397 Directive (EU) 2016/97, 20 January 2016 on Insurance Distribution (recast) (OJ L 26/19, 2 February 2016)
398 Written evidence from Funding Circle (FRS0033)
399 Written evidence from LSEG (FRS0047)
400 Written evidence from Funding Circle (FRS0033)

re-authorisation inside the EU in instances where risks were deemed too severe by EU regulators.

14. LSEG were "very much concerned by the proposal of the European Commission to impose the location of the most substantially important third country CCPs in the EU as it would necessarily create additional artificial costs and systemic risks, due in particular to a market fragmentation (EU and international markets being dislocated)".[401] Graham Bishop, a financial consultant, was however sympathetic: "The sheer magnitude of a potential CCP failure could de-stabilise the EU-27's financial, economic and eventually political systems."[402]

Payment systems

15. Mastercard explained that the payments sector:

> "Comprises the wide array of means by which individuals or organisations can transfer funds between each other. It encompasses cash, cheques, ATM transactions, credit and debit cards, as well as a variety of inter-bank transfer mechanisms including direct debit, Faster Payments (used for mobile and online banking) and CHAPS (used for high value transactions)."[403]

16. Payments systems are an area in which the UK has a strong lead, and the current domestic regulatory structure for payments systems incorporates both the Treasury and the Payments System Regulator, instituted in 2014. Payments systems are affected by the EU's Interchange Fee Regulation (IFR) and by the second Payments System Directive (PSD II), the latter sitting alongside the UK's parallel Open Banking initiative, which in some cases generates conflicts with the maximum harmonising PSD II. Mastercard were concerned that PSD II "will have an enormous impact on the payments sector, but yet its status in the UK following Brexit remains unclear". Which? concluded that "the potential opportunity to diverge from PSD II after Brexit may allow the development of a more effective UK market in payment services".[404]

401 Written evidence from LSEG (FRS0047)
402 Written evidence from Graham Bishop (FRS0001)
403 Written evidence from Mastercard (FRS0036)
404 Written evidence from Which? (FRS0045)

APPENDIX 6: GLOSSARY

AIFMD	Alternative Investment Fund Managers Directive
Acquis communautaire	The accumulated legislation, legal acts, and court decisions which constitute the body of European Union law
Article 50 (TEU)	Sets out the procedure by which a Member State can leave the EU
BBB	British Business Bank
BCBS	Basel Committee on Banking Supervision
BRRD	Banking Recovery and Resolution Directive
CCP	Central counterparty, also known as a clearing house
CETA	Comprehensive Economic and Trade Agreement (with Canada)
CJEU	Court of Justice of the European Union (often referred to as the ECJ)
CMU	Capital Markets Union
CRA	Credit Rating Agency
CRD	Capital Requirements Directive (and Regulation, collectively known as CRD IV)
CSD	Central Securities Depositary
EBA	European Banking Authority
ECB	European Central Bank
ECOFIN	Configuration of the Council of Ministers dealing with economic and financial matters
ECON Committee	European Parliament Economic and Monetary Affairs Committee
EEA	European Economic Area
EFTA	European Free Trade Area
EIB	European Investment Bank
EIOPA	European Insurance and Occupational Pensions Authority
EIS	Enterprise Investment Scheme
EU-27	The remaining EU member states following Brexit
EMIR	European Market Infrastructure Regulation
ESMA	European Securities and Markets Authority
ESAs	European Supervisory Authorities

FCA	Financial Conduct Authority
FPC	Financial Policy Committee of the Bank of England
FSB	Financial Stability Board
FTA	Free Trade Agreement
FinTech	The application of technology to financial services
FRTB	Fundamental reiew of the trading book
G20	The Group of 20, comprising 19 of the world's largest national economies and the European Union
G-SIBs	Global Systemically Important Banks
G-SIIs	Global Systemically Important Insurers
GDPR	General Data Protection Regulation
IAIS	The International Association of Insurance Supervisors
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
Lamfalussy process	System of agreeing legislation in EU financial services
MiFID II	Markets in Financial Instruments Directive/ Regulation
NCA	National Competent Authority
OTC	Over The Counter: refers to securities traded in a context other than on a formal exchange
Passporting	The right for a firm registered in the EEA to do business in any other EEA state without needing further authorisation
PSD II	Second Payments Systems Directive
PRA	Prudential Regulation Authority
Regulatory sandbox	The FCA's regime for FinTech supervision, part of Project Innovate
SMR	Senior Managers Regime
Solvency II	The EU's prudential regime for insurance
TEU	Treaty on the European Union
TTIP	Transatlantic Trade and Investment Partnership
UCITS	Undertakings for Collective Investment in Transferable Securities