Response to the House of Lords European Union Committee Financial Affairs

Inquiry into financial regulation and supervision following Brexit

Submission made by UK Finance

Introduction

1. This is **UK Finance's** response to the House of Lords inquiry on financial regulation and supervision following Brexit. We welcome the opportunity to provide our views. Established on 1 July 2017, UK Finance is a trade association representing nearly 300 of the leading firms providing finance, banking and payments-related services in or from the UK.

Executive summary

2. **It is not realistic to expect the UK to have complete freedom to regulate financial services while at the same time affording UK financial services firms' levels of market access to the EU comparable to those they enjoy today.** The extent to which this will limit the scope of the UK to set its own framework autonomously will be defined by the negotiation of the relationship between the UK and the EU and, as today, by the global frameworks that now underpin much UK and wider EU financial regulation. There is no reason to assume that this must be bad in principle for innovation or that it impedes a desirable level of regulatory discretion for the UK. There are risks and costs to both competitiveness and ease of cross-border trade in a UK regime that diverges too far from the EU.

3. **The EU applies the concept of 'equivalence' to determine access to the EU market for non-EU firms in some areas, but it is not a feasible basis for a cross-border trading relationship that retains many of the benefits of the EU-UK status quo.** Substantial areas of banking business, including deposit taking and lending, are not covered by the EU's equivalence provisions for cross-border contracting. As such the EU's current equivalence provisions would at best provide for a limited patchwork of services to be available, ill-suited to meet the needs of businesses and other customers in the EU, especially the needs of EU-based businesses that are exporters. Moreover, in the limited instances where equivalence could apply, it does not provide a stable basis for mutual access as it can be withdrawn without consultation or notice. As such, the EU's current application of equivalence is perceived as an unstable and unsuitable mechanism on which to base long term investments. Enhancing the existing equivalence concept to make it 'fit-for-purpose' to serve as the basis for an EU-UK relationship would require a root and branch reform of the existing EU approach and it is not evident that this would appeal to the EU, in particular since such an approach would necessarily be applicable for all third countries. UK Finance believes that the EU and the UK should rather aim to develop a new framework between them as the basis for cross-border trade in banking and capital market services founded upon the principle of reciprocal recognition of the standards and authorisations of both sides, includes close comparability in regulatory frameworks for activities where appropriate, and is underpinned by a high level of consultation, convergence and transparency on regulation, as well as cooperation on supervision. This could be embedded in a new EU-UK agreement.

4. **Within the general prudential landscape they cover, the gaps in international frameworks for financial services regulation are generally at the level of detail. The priority is maintaining as much consistency as possible across jurisdictions.** As financial services rulemaking cascades

from the international standard-setting level and is reflected in local financial services rulemaking, it is important that the implementation of globally accepted standards is as consistent as possible and does not disadvantage UK financial services firms from competing.

5. **The question of whether it is in the UK interest to diverge from an EU rule framework will always depend on the impact on trade or the treatment of UK operations inside the EU – or more widely.** In principle, there could be elements of the EU prudential or consumer protection regime that could be better calibrated for the specific profile of UK banks or building societies. But judging the impact of such deviation is only possible when it is possible to assess the consequent impact on the UK's access to - or treatment in - important markets such as the EU. Such deviation could also impact trade with markets that have set the EU benchmark as their own. Such judgements will always be contextual ones.

6. **Any deep cross-border relationship between the EU and the UK after Brexit will require mechanisms for scrutinising regulatory convergence and divergence between the two parties – backed up by a clear process for enforcing commitments and resolving any disputes.** The deeper the cross-border relationship and the regulatory convergence, the stronger these mechanisms will need to be. How they will be designed will be a question of what both sides will find acceptable in terms of regulatory and legislative cooperation and consultation, supervisory cooperation and willingness to submit to independent arbitration mechanisms over which the parties have little control or influence. These are political as well as legal and practical questions.

<u>Current regulatory regimes</u>

Question 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?

7. It is axiomatic that the outcome of a policy-making process covering a broader geographic area, and a more diverse set of stakeholders, will not be exactly the same as the outcome of a process covering a smaller geographic area. From the perspective of a business providing financial services to clients located in different countries, there is a very major advantage for policy measures to have a broader, rather than a narrower, geographic scope, so that the business is faced with one set of rules rather than many. This harmonisation is a necessary part of building a true single market out of the EU's constituent markets. UKF is of the view that over the past twenty years London as a financial centre has benefited considerably from rules being increasing set at the global and at the European levels.

8. There are two possible concerns with respect to rules set at the European level. The first is that EU-level rulemaking could in theory be technically or conceptually flawed in a way rules made in the UK are not. Although we do agree that many European rules are not perfect (as, for example, the European Commission's 2015/2016 call for evidence on the EU regulatory framework has shown), we do not believe that there is evidence to suggest that rules set at the EU level (or at the global level) are of less good quality than rules set at the UK level. Even if this were to be the case, such disadvantages could still be outweighed by the advantages of having to deal with one set of rules (rather than multiple sets). The second concern is that EU rules may breach principles of subsidiarity and of proportionality (i.e that rules set at the EU level are not appropriate for smaller financial service providers in particular operating in markets that are nationally based, and not exposed to international competition). We note, for example, that one aspect of EU financial services policy has been to take measures to try and break down barriers between segmented national markets across the EU, and to create a single market. Such measures have inevitably involved costs for existing national market providers, but without the certainty that it would be possible to create a single market. We believe that these are important questions for discussion, but at the same time it is not possible to conclude that EU policy is necessarily inappropriate. Relevant considerations include the reality that compared to smaller markets, larger markets provide greater benefits to their participants, and the expectation that technological developments will create the opportunities for greater cross-border activities.

9. 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. The financial services regime has

continued to evolve in response to events and has increasingly been informed by global standards. The banking sector as a whole has continued to benefit from this regulatory framework and its development. Since the financial crisis, the framework has provided the conditions for a stable financial environment that enables competition, the requirements to treat customers fairly and a robust enforcement regime that deters misconduct by individuals as well as by firms. It is particularly effective for UK Finance's largest members where the common approach to regulation promoted by the EBA's single rule book enables them to operate across borders to a substantially similar set of regulatory requirements.

10. The EU has always faced the challenge of regulating a market with an exceptionally diverse set of financial services businesses. This has sometimes made it challenging to devise a regime that suits the French, German and British banking systems, for example, which differ in some respects. It has also often presented a challenge in designing regulation that works well both for large and small financial institutions. It should be noted however that the existing EU regime has still enabled the UK able to pursue an extensive approach to domestic regulation after the financial crisis, frequently 'gold-plating' EU requirements.

11. It is important when thinking about the future of the UK financial services regime in relation to the EU to recall that while there have been elements of this regime which the UK has opposed or criticised, overwhelmingly this is a framework that the UK has endorsed and in most cases played a key role in designing. Areas of particular UK influence have included securities laws and insurance supervision.

Question 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?

12. Current EU policy with respect to financial services is focused on the creation of a well-functioning financial system in the single market. The EU will look to reduce risks and make banks more resilient. Principal elements of the EU's proposals are the proposed completion of the Banking Union and the delivery of the Capital Markets Union (CMU). With respect to the Banking Union, the completion of the second (the single resolution mechanism) and third pillar (the European Deposit Insurance Scheme) is aimed at ensuring a resilient banking sector. The completion of the CMU is aimed at strengthening the internal market for financial services and will look to implement the mid-term review action plan of June 2017. The CMU is key to providing more diversified access to funding sources, increasing the overall resilience of the financial sector and contributing to overall financial stability. Beyond the Banking Union and Capital Markets Union, the EU will look to foster diversification of bank balance sheets.

13. There is a great diversity in current (and potential) EU legislative proposals relating to banking and financial services. We believe that some proposals are misconceived, such as the proposal relating to the mandatory creation of 'intermediate holding companies' (which aims to improve banking group resolution but has significant downside), while other proposals, such as the European Commission proposal of 4 May 2017 to amend EMIR, have many positive elements. While many elements of the EU's current proposals are likely to contribute to financial stability – subject as always to the evolution of their detailed provisions and the method of implementation – other elements, if not developed in a balanced manner, appear to run the risk of fragmenting markets and impeding the provision of capital and services to EU customers,

14. The EU financial services regime reflects many of the standards set by the global standard setting bodies such as the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO), the Financial Stability Board (FSB) and the International Association of Insurance Supervisors (IAIS), with the aim of enhancing the stability of the financial system. The EU regulatory framework contains requirements that express its commitment to the G20 agenda. The UK is represented in international financial regulatory fora and is regarded as an important voice.

15. We believe that the major elements of the EU's post-crisis regulatory repair agenda have been delivered. There is currently a 'jobs and growth' agenda, of which important elements include the CMU project, and targeted amendments to existing legislation. With regard to the future regulatory agenda, we believe that important elements of this will include initiatives relating to sustainable finance, including investment needs relating to climate change, to the risks and opportunities of new technologies, as well as to tax fairness, and to transparency. Brexit itself will impact EU financial service policy, as it is to be expected that the EU27 will try and build up EU27 capital market capabilities.

Question 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?

16. The UK exit from the EU comes after a period of high publicity around the capacity of interconnected financial markets to contaminate each other, which has propelled a significant degree of international regulatory convergence through standard-setting bodies such as the BCBS, IOSCO and the FSB. International standards set by such bodies tend to operate at a sufficiently high level of generality to leave room for adaptation to local circumstances, and represent minimum requirements for good supervisory practice. At the EU level, financial services regulation is about the application of these standards, via directives or regulations. At the UK level, financial regulation is about the transposition of these EU rules and regulations and decisions about the exercise by the UK authorities of any national options and discretions where permitted by the EU. The EU has implemented international standards whilst including national options and discretions that enable individual competent authorities to recognise national specificities and as such has not always been fully compliant with internationally agreed standards. Examples of this include the concessionary risk weighting for SME exposures and the treatment of investments in the capital instruments of insurance company subsidiaries. It would be preferable for the EU to raise specificities at the stage of global rule-making to avoid an unlevel playing field. The UK on the other hand has a tendency to gold-plate the implementation of EU and international standards. Examples of this are the reporting to the PRA of liquidity positions (which exceed EU requirements) and the PRA's current proposals on cash flow mismatch risk (which exceed current Basel Committee internationally agreed liquidity standards).

17. As financial services rulemaking cascades from the international standard-setting level and is reflected in domestic financial services rulemaking, it is important that the implementation of globally accepted standards is as consistent as possible and does not disadvantage UK financial services firms from competing in multiple countries. Any gaps tend to be in areas where standards have not developed or have not been the subject of international discussions.

Question 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?

18. The main challenges derive from the large volume of existing EU legislation that will have to be reviewed, and from the risk of unexpected and unintended consequences. It is important that the greatest possible clarity is provided on the existing and in-flight law applicable to banking and financial services activity in the UK at the point of exit from the EU. This is required for ongoing financial stability and business continuity, as well as to ensure the ability of both domestic and foreign banks based in the UK to continue to serve their customers and clients with a minimum of disruption and maximum legal certainty.

19. UK Finance is of the view that the Government's proposed approach for the domestication of EU law in the UK under the European Union (Withdrawal) Bill is the best one for this complex and unprecedented task. There will be areas in which amendment of the aquis will be required to fix any provisions that would be inoperable given that the UK is no longer part of the EU – examples of this are the reallocation of powers currently delegated to EU agencies, the reassessment of the rights of EEA firms in the UK market, the recognition of trading venues and central counterparties (CCPs) and the application of the bank recovery and resolution directive.

20. UK Finance believes that this exercise should not extend to discretionary policy changes at this time. Given the scale of the exercise, we do not consider there to be any area of banking or markets legislation in which the case for immediate policy change is sufficiently compelling or urgent so as to outweigh the overriding priorities of continuity and certainty. UK Finance strongly endorses the view that the priority for UK-based banking, payments and capital markets businesses is the absolute minimum of change in their day-to-day operating and regulatory obligations and requirements as the UK exits the EU. It also believes that stability in UK approaches to financial regulation is important while the UK and the EU consider their future relationship.

21. It is also important to stress how fundamental the legal exercise – which includes the transposition but also the establishment of a cross-border civil judicial cooperation framework - proposed by the European Union (Withdrawal) Bill is for UK businesses in all sectors. While there are important questions of transparency and accountability attached to such a huge legislative exercise, it is vital that the legislative process itself is not held hostage by political disagreements in such a way that jeopardises the transition in legal regimes envisaged by the Bill.

22. 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.

23. **We refer the Committee to two prior submissions to Parliamentary committees on EU matters:**

    (i) the UK Finance (then BBA) submission in June 2017 (Feedback on the White Paper by the British' Banking Association – Legislating for the United Kingdom's withdrawal from the European Union); and
    (ii) the UK Finance (then BBA) submission made in January 2017 to the Treasury Select Committee (response to the Treasury Select Committee request for written evidence on Transitional Arrangements).

Transition, equivalence and alignment

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

24. In her recent speech in Florence, the Prime Minister proposed an implementation period after the UK leaves the EU, during which access to one another's markets should continue on current terms. It was also recognised that businesses should only have to plan for one set of changes in the relationship between the UK and the EU.

25. The following priorities should be provided for in order for such an implementation or transitional period to work[1]:

    - There must be an early and bilateral reciprocal commitment that can be relied on with a strong degree of confidence. Banks are looking to have their Brexit plans substantially in place by the end of 2017 and any commitment on transition after the first quarter of 2018 will have diminishing value as time passes;

    - It must provide for the preservation of financial stability and cross-border supervisory cooperation;

    - It must provide for contractual certainty for parties to cross-border financial services contracts that extend beyond the date of UK exit from the EU, if these would otherwise be rendered in any way unlawful, unenforceable or inoperable by the change of the UK's status under EU law (and/or the

[1] See also the UK Finance (then BBA) reports: Time to adapt: achieving and orderly transition for banking and Time to adapt: an EU customer perspective and the Boston Consulting Group report: Bridging to Brexit: Insights from European SMEs, Corporates and Investors.

law and regulation of EU member states) or by the change in the EU's status under the law and regulation applying in the UK[2];

- There should be no change to applicable rule and regulation at the point of time of Brexit; this is to avoid any need for two sets of changes (i.e. changes at both the start and the end of the transition period); any necessary changes should take place at only one point in time;

- It must provide for the unfettered continuity of business activities, both existing and new, to avoid a 'chilling effect' on commercial activity with deleterious consequences for jobs creation and economic growth;

- It must provide for a bridge to a future trading framework where this can be anticipated to prevent businesses from restructuring contracts or operations unnecessarily, and time to negotiate that relationship so as to provide long-term certainty following the end of the transitional arrangements; and

- It must provide time for UK and EU customers to adapt to any expected loss of rights in way that is orderly and minimises disruption to customers and markets.

26. **We also refer you to the UK Finance (then BBA) submission made in January 2017 in response to the Treasury Select Committee request for written evidence on Transitional Arrangements.**

Question 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?

27. The challenge is that for transitional arrangements to be effective, they must be committed to as soon as possible as part of the second phase of the UK and EU negotiations and not later than the first quarter of 2018. That is clearly not straightforward as a political matter. It also reverses the usual practice of agreeing transitional arrangements towards the end of a negotiation process. However, the unique circumstances of the UK leaving the EU create unique risks, and may result in significant adverse consequences for the UK, the EU27 and their businesses and consumers. This includes the risk of businesses making precipitous, costly – and potentially premature – decisions about the structures of their operations and their dealings with customers, suppliers or other cross-border relationships.

28. Without an up-front commitment on transitional arrangements, many banks and their customers will be compelled to proceed on the prudent assumption that there will be no transitional arrangements. UK-based banks may start to withdraw services from a wide range of EU27 customers and vice versa, and banks and/or their customers may take irrevocable steps to restructure or terminate contracts or lines of business. This will be a particularly unfortunate outcome if the eventual terms of the new partnership between the UK and the EU27 are such that this kind of forced action was not in fact needed.

29. **We refer the Committee to the UK Finance (then BBA) submission made to the Treasury Select Committee in January 2017 (Response to the Treasury Select Committee request for written evidence on Transitional Arrangements).**

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

30. The EU passport is well-established in banking services. The banking passport allows banks to provide banking services throughout the EU, either directly from their home country or via branches established in another member state that do not require the authorisation of the host member states. EU member states have full access to the single market and benefit from all passporting rights. Beyond the EU, passporting rights are only available to firms established in non-EU member states of the European Economic Area[3].

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[2] See also the UK Finance/AFME note: The impact of Brexit on cross-border financial contracts.
[3] See also the UK Finance (then BBA) Brexit Quick Brief: What is 'passporting' and why does it matter?

31. Contrary to the EU passporting regime, the EU concept of third country 'equivalence' reflects a much more piecemeal approach and, insofar as it affects EU market access, it does not cover important banking services such as deposit-taking and lending. Equivalence can only be granted by EU authorities where it is explicitly provided for in EU legislation - since it is not available with respect to the provision of all services, or the servicing of all client types[4]. In some cases 3rd countries are not empowered to request an equivalence review, instead requiring sponsorship from Member State authorities.

32. Equivalence provisions are tailored to the needs of each specific act and their meaning varies from one legal text to another. Equivalence is assessed by the European Commission. There is currently no established framework for determining how equivalence will be assessed which creates a high degree of uncertainty. There have also been examples where the Commission has adopted a rigid approach to assessing equivalence where it has performed line-by-line comparisons of regulatory regimes, rather than adopting an outcomes-based approach. This has led to very drawn out procedures for making equivalence decisions as evidenced by the US-EU central counterparty (CCP) equivalence decision which took several years to be made.

33. In addition, equivalence does not provide a stable basis for mutual access as it can be withdrawn without prior consultation with the other jurisdiction and without a notice period. As such it is perceived as an unstable and unsuitable mechanism on which to base long term investments. It should be noted that with respect to the equivalence review that was recently announced by the European Commission it is expected that this will result in a more stringent approach going forward.

34. This means that in comparison to passporting, market access provided by EU equivalence is not as powerful a way of liberalising international trade in financial services. The EU's current equivalence provisions would at best provide for a limited patchwork of services to be available and are ill-suited to meet the needs of businesses and other customers in the EU, especially the needs of EU-based businesses that are exporters. As described below in response to Question 8, enhancing the existing equivalence concept to make it 'fit-for-purpose' to serve as the basis for an EU-UK relationship would require a root and branch reform of the existing EU approach and it is not evident that this would appeal to the EU, in particular since this would necessarily be applicable for all third countries.

35. UK Finance believes that the EU and the UK should rather aim to develop a new framework between them as the basis for cross-border trade in banking and capital market services that is based on the principle of reciprocal recognition of the standards and authorisations of both sides, includes close comparability in regulatory frameworks for activities where appropriate, and is underpinned by a high level of consultation, convergence and transparency on regulation, as well as cooperation on supervision. This could be embedded in a new EU-UK agreement.

Question 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?

36. It has been proposed that 'equivalence' in its current limited form could be enhanced to maintain alignment between the UK and the EU and could form the basis for future market access. This model however would require two major areas for development: Firstly a 'root and branch' reform of the EU's current approach to 'equivalence' to both expand its current limited scope to all pertinent financial services and also to transform the basis on which equivalence is assessed so that is becomes a consistent, open, objective and transparent process. Secondly the need for a bilateral agreement/treaty that would address concerns around the risk of equivalence recognition being withdrawn without due process and at short notice. An approach of enhanced equivalence would require the EU to open up any alignment with the UK and also consider the impact on third countries other than the UK.

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[4] See also the UK Finance (then BBA) Brexit Quick Brief: What is 'equivalence and how does it work?. Also see the IRSG report: the EU's third country regimes and alternatives to passporting.

37. An alternative model, and the UK Finance preferred model, would be one based on mutual recognition with a high degree of regulatory alignment and supervisory cooperation as the basis for a high level of cross-border trade in banking and capital markets services between the UK and the EU. Such a model for trade in financial services between the EU and the UK would need, for both parties, to:

- Regulatory alignment, reciprocal market access and a level playing field;

- Respect for the desire of the EU and the UK to have the freedom to regulate and to have autonomy over its legal regime;

- Build on the commonalities and longstanding trust in each other's systems and the uniquely close starting point between the UK and the EU;

- Combines existing tools that are well recognised and utilized in a variety of trade agreements with elements from existing tier one national licensing regimes that are in place alongside EU level policy approaches or in other important jurisdictions; and

- Be flexible and also readily adaptable to be used for other sectors of the economy if desired.

38. There is no material obstacle to the UK and the EU agreeing an ambitious regime that allows a high level of cross-border trade in banking and capital markets services between them. This could be embedded as part of a Free Trade Agreement ('FTA') or in a standalone framework alongside an FTA. While historically the coverage of services in FTAs has been limited, there is nothing in the FTA model to prevent it from being used for the ambitious cross-border liberalisation of trade in financial services. Previous FTAs provide useful precedents, but the degree of integration between the UK and the EU makes the future partnership unlike any other existing arrangement. It will be a question of resolving the practical, political and prudential questions raised by cross-border trade between two separate financial jurisdictions. How far the two sides are willing to go in pursuing this, and the extent to which such an agreement requires the UK to adopt or mirror EU standards, will be a question for authorities on both sides.

39. Any model would clearly require an independent mechanism for arbitrating disputes and enforcing its implementation. There are several different approaches that could be taken to this, ranging from the kind of conventional state-to-state dispute resolution mechanism common to most bilateral FTAs and the WTO's Dispute Settlement body, to a much more sophisticated arbitral body that has legal power to compel authorities on both sides if they were found to have breached the agreement. This is ultimately a question for the UK and the EU as it goes to the heart of issues of submission of disputes to supranational authorities. It is very important that dispute resolution mechanisms that apply to the financial services sector incorporate adequate market expertise. This expertise must not only concern financial regulation itself but also an appreciation of the roles that financial services and markets play in the economy as a whole.

The future environment

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

40. For a number of key financial products and services the UK is by far the most important service provider in the single market, including in foreign exchange, capital markets products and derivative instruments/risk management products. The provision of some of these key services may fragment after the UK exit from the EU and move into the single market, and some may move elsewhere.

41. The UK market is a major gateway between the EU and the global capital markets. As a result of market fragmentation, some of the global integration may be reduced and impact on the ability to compete for global financial services business. The exit of the UK may have an impact on the diversity

of the EU as a financial services centre across primary, secondary and derivatives markets as providers evaluate the cost and benefits of services in certain market segments. Any market fragmentation or limitation on cross-border transactions is likely to increase costs, reduce choice, and limit service availability for end users, damaging economic growth and the competitiveness of the European capital market.

42. The EU will, post UK exit, develop financial services policy without the UK as a member state. This may affect the way the EU considers questions of third country treatment and there is a risk that a 'Fortress EU' approach will place greater constraints on access, or impose higher costs on access, to the single market than apply today. One undoubted benefit of the UK's involvement in the development of EU financial services legislation has been the UK's experience of regulating the largest financial market in the EU, namely the City of London. While the UK has not, of course, always agreed with EU legislative proposals, it is important to appreciate that areas of strong disagreement have been isolated and fairly infrequent, and that the UK's participation in negotiations has helped to 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.

43. UK Finance believes that it will be of mutual benefit for both the EU and the UK in achieving the EU's desire for the healthy development of stronger financial services and capital markets to ensure that the future relationship between the EU and the UK encourages deep and extensive interaction between the UK's and the EU's markets.

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

44. Since, to our knowledge, third country equivalence under EU financial services legislation has never been withdrawn, it is hard to say with certainty what the threshold for its withdrawal is or will be; it is unlikely to be the same in all contexts. In principle, EU equivalence regimes are based not on line by line comparisons of legislation but on comparisons of intent and substantive outcome in third country regulatory regimes. However, in practice, the EU approach often relies on a consensus between national regulators in EU member states, the ESAs and the European Commission, and some state regulators are more inclined to treat equivalence on a line by line basis than others.

45. How this might work in a UK-EU context would be a question of negotiation and evolved practice. It suggests some acceptable scope for varied approaches at the level of, for example, detail in consumer protection regulation, but more limited scope for serious divergence in minimum prudential regulatory standards, especially if the UK were to be perceived to be undercutting EU prudential regulatory standards in order to attract business. In many areas of banking prudential supervision, the tendency of UK regulators has, however, been to 'gold-plate' and apply stricter standards in prudential supervision than is required under EU law.

Question 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?

46. The challenge that innovation always presents for regulation and supervision lies in their ability to adapt quickly and dynamically to reflect and absorb new services, technologies and products. Regulation that does not do this can present both a check on innovation and a source of risk, if areas of activity develop outside of the scope of appropriate regulation – as they arguably have in some areas of Fintech. Industry regulators always face a challenge in assessing and balancing the benefits of new approaches with the level of disruption they cause.

47. As it generally does now, UK financial services regulation post-Brexit should take a risk-based and proportionate approach to innovation and technology-enabled products and services in order to ensure that they are introduced responsibly. Above all, regulation should focus on outcomes and the activity being performed as opposed to any attempt to regulate the technology itself (technology neutrality).

Regulators and industry should continue to collaborate closely on best practice, risk awareness and building regulatory capacity to understand the innovation frontier - concepts like the regulatory sandbox are an important example of this that the UK has pioneered.

48. The right balance also needs to be struck between statutory standard setting and the capacity of supervisors to evolve rulemaking and regulatory guidance in a more dynamic way to reflect technological and market change. In principle, Brexit will enhance the UK's ability to do this by increasing its legislative autonomy in some areas.

49. However, because regulation can and must evolve with innovation, it is important to recognise that it is a potential source of regulatory divergence between jurisdictions. This can have implications for trade and the UK's value as a testbed for innovation. It can also present an element of systemic risk. The FSB has recognised this development in a recent paper on Fintech and called on financial regulators to develop better relationships with each other and with their peers in other industries in order to ensure effective oversight and coordinated approaches to regulatory design. By using its existing leverage in international fora the UK should be a vocal advocate for the sensible harmonisation of regulatory approaches to FinTech and technology. This is likely to be a central plank of any future UK cross-border access to the single market in areas such as Fintech and more widely.

50. It is also important to ensure that the market access commitments that the UK secures in other markets are innovation-proof. At the most basic level this can be done through ensuring that market access rights are subject to a 'new services' clause that automatically extend them to any new services authorised by the local regulator.

Question 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?

The UK authorities and industry enjoys deep skill and expertise in financial regulation which is internationally recognised and appreciated. As an EU member state, this concentrated expertise enables the UK to exert considerable influence over the design of EU regulation. If the UK's position as a global financial centre suffers real damage following the UK's withdrawal from the EU, then the UK's influence in these fora may be diminished. The involvement of the UK at international fora will need to be structured and coordinated to ensure that it can put forward prudentially sound and consistent positions which also contribute to enhancing further the role of the UK as a financial centre. The degree of influence that the UK will be able to exert is difficult to assess because it will, of course, also depend on the stances taken, and in some cases the level of engagement in international fora, by other countries and trading blocs with large financial sectors.

Supervision

Question 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?

51. The ESAs play an important role in the EU regulatory landscape. They are likely to play an important role in the implementation and on-going monitoring of whatever arrangements are decided for regulatory supervision and alignment between the UK and the EU in respect of trade in financial services as part of a long term partnership agreement.

52. On September 20, the European Commission announced proposals for the creation of a stronger and more integrated European financial supervision for the CMU. The proposals firstly shift the balance of power towards the EU and away from national regulators and secondly significantly increase powers of direct supervision over capital markets, and not just in relation to EU firms, but also those from third countries. Added together, the picture is of a much more powerful set of EU regulators prepared to reach beyond their borders to protect financial stability and prevent regulatory arbitrage. A more

powerful role for ESAs should come with clear safeguards to ensure the risk of influence by any political considerations is avoided.

53. The ESA review also gives the ESAs more power in relation to outsourcing/delegation from EU banks to third countries which may scale and scope of such activities currently undertaken in the UK on behalf of EU entities/funds.

Question 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?

54. Consideration about the future role of the ESAs is particularly pertinent with respect to financial market infrastructures (FMIs), such as CCPs. These reduce system risk by becoming the buyer-to-the-seller and the seller-to-the-buyer in securities and derivatives markets, a process that ensures that transactions can be completed if one party proves unable to complete its side of the trade. This also increases market efficiency through the netting of trades between counterparties, freeing liquidity and capital for use elsewhere.

55. On 13 June 2017 the European Commission proposed legislation aimed at to altering the CCP third country regime to classify CCPs based on their size and 'systemic significance' to the European markets. The proposal introduces a two tier system for the recognition and oversight of third-country CCPs. Non-systemically important CCPs (Tier 1) would continue to be subject to the current arrangements and conditions for third-country CCPs. Systemically important CCPs (Tier 2) would be subject to a sliding scale of heightened EU oversight. Those of 'substantial systemic significance' to the EU could be denied recognition and therefore subject to an EU authorisation and establishment requirement in order to provide services to EU counterparties. ESMA and the ECB would determine a CCP's tier based on a number of criteria, including its size and complexity, its impact on financial stability and its interdependence with other financial institutions and FMIs.

56. A third-country Tier 2 CCP would be able to continue current operations provided that the CCP complies with certain conditions, including prudential requirements set out in the European Market Infrastructure Regulation (EMIR), agrees to provide information and access to ESMA, and complies with requirements imposed by the ECB in relation to its monetary policy tasks and provided that ESMA concludes that such compliance sufficiently ensures the financial stability of the EU. The proposal, however, does not distinguish between a UK-based CCP's EU-related activities and its other business.

57. As a result, the entirety of a Tier 2 CCPs' UK-based activities would have to comply with EU requirements; including those segments that are not directly related to the EU financial system, such as US dollars or Japanese yen swap clearing. This may risk putting CCPs in a position where they are forced to "split" their activities into an EU and a non-EU entity, which would significantly increase operating costs and increase risk for users of the market.

58. The ECB has subsequently proposed an amendment to its Statute which would grant it the competence to regulate clearing systems – a competency it was judged not to have in the 2015 judgement of the European Court of Justice which annulled the Eurosystem Oversight Policy Framework. The amendment to Article 22 of the ECB Statute is intended to "provide the ECB with a clear legal competence in the area of central clearing…(paving) the way for the Eurosystem to exercise the powers that are foreseen for central banks issuing a currency under the review of the EMIR proposed by the European Commission".

59. UK Finance is pleased to see that the European Commission is not proposing a policy of automatically requiring all CCPs engaging in the clearing of euro-denominated transactions (i.e. "Euroclearing") to be located within the EU. However, the ability to deny recognition to a third-country CCP could lead to market fragmentation, with negative impacts on impacts on market efficiency, financial stability and end-users. We support the principle of robust EU-wide supervision and approve of the Commission's recognition of the importance of CCPs to the global financial framework. UK Finance believes there is

a strong possibility that an acceptable supervisory and regulatory framework, with equivalence of CCPs based in both the EU and the UK, can be agreed.

60. We are concerned, however, that the proposal could apply EU supervisory requirements to the entirety of a third country CCP's business, as opposed to its business relating to Euroclearing only.

61. UK Finance notes that the precise details of the criteria that the ECB and ESMA will use in recommending CCP tiering to the Commission will not be known for some time, and that there is a risk that these criteria will not be known before the exit of the UK from the EU in March 2019. This exposes UK-based CCPs to a high degree of uncertainty.

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

62. The proposed amendment to the ECB Statute would give the ECB the power to regulate clearing in the EU, although we note it has not been made clear whether or not this would grant the ECB competence to operate within the proposed new framework of EMIR or to go beyond that. The amendment leaves open the possibility that the ECB could regulate clearing beyond what is laid down in EMIR. UK Finance believes that the ECB should operate within the EMIR framework to provide certainty for firms and other users of the market.

63. In terms of potential risks, there is a real risk of policy differences arising between the ECB, ESMA and the Bank of England. Coordination between regulatory authorities is critical during business-as-usual but particularly in times of stress. Situations that would require close coordination should be identified in advance and procedures agreed for how to address them – ideally based on global guidance. A common set of standards would facilitate alignment of actions in a stressed environment, reducing financial stability risks and increasing certainty for market participants. Global standards setting bodies such as the FSB have already issued guidance which addresses certain risks. For example, the FSB's July 2017 Guidance on CCP Resolution and Resolution Planning includes a recommendation for the establishment of Crisis Management Groups for CCPs that are systemic in more than one jurisdiction, including home and host supervisors of the CCP and its major clearing members and central banks of the currency of issuance of the products it clears in significant volume. Similarly, the FSB's Guidance on Continuity of Access to Financial Market Infrastructure for a Firm in Resolution sets out procedures to ensure that a GSIB in resolution is able to continue to access critical infrastructure such as CCPs during its resolution, regardless of jurisdiction. Such arrangements are necessary to address how these issues would be resolved, particularly in a crisis situation, and we would like to see further clarification on this matter in the Commission proposal.

64. The Commission's proposal includes a concept of "comparable compliance" akin to the US Commodity Futures Trading Commission's (CFTC) "substituted compliance" for non-US CCPs, which allows them to follow local regulation in a series of operational areas, including the posting of initial margin and collateral segregation. Under the Commission's proposal, a third-country CCP can request ESMA to compare EMIR's requirements and EU supervisory standards for CCPs with those of the third country. Where comparable, ESMA may determine that the application of some or all of the requirements in place as well as the corresponding supervisory enforcement in that third country provide a comparable outcome to the application of EMIR and waive the application of corresponding EMIR provision. To work effectively it is vital that this framework is applied in a proportionate and outcomes focused fashion, rather than a line-by-line comparison of the rules in different jurisdictions.

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