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Brexit and financial services

By Steve Browning
Federico Mor

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Summary

Financial services are an important part of the UK economy, making up 6.9% of total output in 2018 and contributing £29 billion in tax in 2017/18. As a major international financial centre, London (and the UK more generally) has benefited from increasingly integrated commercial and regulatory relationships with the EU.

The vote to leave the EU presents a range of challenges for the sector. Membership of the Single Market has allowed financial businesses authorised in any Member State to operate freely across the European Economic Area (EEA). This system – known as passporting – reflects both the EU's overall political aspirations and a more practical alignment of regulatory systems in each Member State.

The logic of Brexit challenges both of those foundations. Once the UK had confirmed its intention to leave the Single Market, the EU explicitly ruled out sector-specific arrangements – such as passporting – that might have maintained existing benefits.

That exclusion led to a focus on the possibilities arising from the existing alignment of regulatory systems – in short, a quest for "equivalence". This is an approach in which states grant market access in specified activities on the basis that the regulations that underpin these activities are deemed to achieve comparable outcomes.

The UK set out its ambitions for negotiation in the Brexit White Paper in July 2018. This highlighted both the interconnectedness of the financial services market and the possibilities for autonomous decision-making. But that second point reflects one of the major challenges of relying on equivalence decisions – they depend on regulatory outcomes remaining compatible, so are subject to review and unilateral cancellation. In addition, the process of agreeing equivalence frameworks can be slow and subject to wider political considerations. Indeed, the EU recently withdrew equivalence from Switzerland, citing not only frustrations with Swiss "delays" on agreeing wider arrangements with the EU, but also comparisons with Brexit.

The Political Declaration that accompanied the draft Withdrawal Agreement aimed to build a more robust and transparent "equivalence plus" regime. This would be underpinned by new institutional arrangements. But the aspirational nature of the Declaration meant that the details remained to be negotiated during the implementation period that would have followed ratification of the Withdrawal Agreement.

The UK Government, the Treasury and the main financial regulators have continued to incorporate EU financial legislation into UK law and regulatory practice. In the event of no deal, the *Financial Services (Implementation of Legislation) Bill 2017-19* would have enabled this to continue for two years after Brexit. However, the Government has not scheduled the remaining stages of the Bill. If it is not passed during the current parliamentary session, it will fall, meaning that maintaining alignment with the EU after Brexit will require new primary legislation.

So a no-deal Brexit makes the quest for equivalence more difficult. Leaving the EU without a deal means that the UK would revert to third-country status. Both parties have made some provision for such a scenario to give some degree of continuity for financial services. For instance, the UK is developing a temporary permissions regime to allow EEA-based businesses to continue to operate in the UK and to seek more permanent authorisation from the Financial Conduct Authority. The UK and the EU have addressed similar risks in the derivatives market (which is heavily concentrated in the UK, even for euro-based business) through agreeing a temporary recognition regime.

1. What's at stake

Financial services are an important part of the UK economy. Overall, financial services contributed £132 billion to the UK economy, representing 6.9% of total economic output in 2018. The sector contributed £29 billion in tax in the UK in 2017/18.[1]

The Government's Brexit White Paper in February 2017 further noted the reach of the sector beyond "the City":

> 8.22 The financial services sector is an important part of our economy. It is not just a London-based sector; for example, two thirds of financial and related professional services jobs are based outside the capital, including 156,700 in Scotland, 54,300 in Wales and 32,000 in Northern Ireland. The UK is a global leader in a range of activities, including complex insurance, wholesale markets and investment banking, the provision of market infrastructure, asset management and FinTech.[2]

The vote to leave the EU has deep implications for the financial services sector. Brexit involves a process of disentanglement of the UK financial services industry from the EU – both in access to markets and future regulatory arrangements. An estimated 10% of UK financial services revenues comes directly from the EU. This means that after oil and gas at around 40% and manufacturing at around 20%, it is the third most reliant sector on the EU market.[3]

Earlier approaches to Brexit had considered the possibility of carrying over "passporting" arrangements, in which businesses registered in one country in the European Economic Area (EEA) are free to operate in any other EEA country. The subsequent political move away from continued membership of the Single Market rendered the possibility of passporting unrealistic, so the focus moved instead to "equivalence".

Equivalence would allow UK and EU financial businesses to carry out specified activities across borders so long as the regulations that underpin these activities in the UK and the EU are deemed to achieve comparable outcomes. This might, for instance, involve considering whether both regulatory systems mitigate specified risks posed by a certain activity to a similar extent.

Continued uncertainty about the future appears to have contributed to moves of corporate headquarters, branches and staff away from the UK. Although the level, causes and effects are open to debate, New Financial, a think tank promoting capital markets, reported in March 2019 that 275 financial institutions had moved or were moving at least part of their operations elsewhere in the EU. [4,5]

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1 House of Commons Library, Financial services: contribution to the UK economy CBP06193.

2 GOV.UK, The United Kingdom's exit from, and new partnership with, the European Union (May 2017).

3 House of Commons Library, Importance of trade with the EU for UK industries, August 2017.

4 New Financial, Brexit & the City – the impact so far (March 2019).

5 See also Bloomberg, Brexit Impact Tracker: How Businesses Are Preparing for Brexit, Deal or No Deal (July 2019).

2. Equivalence

There are essentially three broad options relating to Brexit and financial services:

1. Continuing with current passporting arrangements
2. Negotiating a new equivalence regime
3. Departure from the EU with no deal and subsequently arranging equivalence agreements.

The first scenario continues the current situation, in which financial services companies are "passported" to offer services across the EEA through membership of the Single Market and implementation of its rules. These arrangements will continue for as long as the UK remains in the EU and would also continue during the implementation period as it was envisaged by the May Government, but not beyond.

For that reason, this briefing focuses on the question of equivalence, which is how the UK and the EU propose to facilitate future cross-border trade in financial services after Brexit.

2.1 From passporting to equivalence

Under Single Market rules, if a firm receives certain regulatory authorisations in one Member State, it obtains passporting rights. These rights allow it to operate and sell in all other EU countries. Many financial firms have chosen to set up in London – which is seen to have advantages over other European cities in financial services – and get authorisation from the UK authorities to then operate freely across the EU.

TheCityUK, a trade body representing the interests of the financial services sector, raised concerns about the loss of access to the Single Market immediately after the referendum:

> The people of the UK have decided that the future of the UK is a new one outside of the European Union. There will be challenges ahead and it will be important for Government and business to work together to address them. Our immediate focus is on stability – in the markets, for investors, and for our industry's customers.
>
> Clear agreement is now needed on the way forward for the forthcoming negotiations as Government shapes a new relationship for the UK with the EU and retains the jobs and investment that the UK has seen to date. For financial and related professional services, the focus is on securing continuing access to the Single Market.
>
> It is vital that action is taken to reinforce the global competitiveness of the UK as a place in which and from which to do business. This will help to mitigate the risk of prolonged uncertainty while a new relationship with the EU is negotiated. We look forward to working with Government on forward-looking policies to help achieve this and to advancing the

> attractiveness of UK-based financial and related professional services.[6]

The EU, for its part, was clear that passporting would not be on offer outside the Single Market. In April 2017 – a week or so after the UK Government invoked Article 50 – an EU Parliament resolution on arrangements for negotiations Brexit noted that the Parliament:

> [o]pposes any future agreement between the European Union and the United Kingdom that would contain piecemeal or sectorial provisions, including with respect to financial services, providing United Kingdom-based undertakings with preferential access to the internal market and/or the customs union; underlines that after its withdrawal the United Kingdom will fall under the third-country regime provided for in Union legislation…[7]

In November 2017, Michel Barnier, the EU's chief Brexit negotiator, reiterated this position:

> Speaking at a Centre for European Reform conference, Barnier said, "On financial services, UK voices suggest that Brexit does not mean Brexit.
>
> He added, turning UK Prime Minister Theresa May's refrain against her, "Brexit means Brexit - everywhere."
>
> He continued, "They say there will be no changes in market access for UK established firms, they say joint UK-EU rules would be decided in a new, symmetrical process between the EU and the UK and outside of the jurisdictions of the European Court of Justice.
>
> "This would contradict the April European Council guidelines, which are my mandate, which stress the autonomy of European decision-making, the integrity of our legal order, and of the single market."
>
> Barnier told the conference, "The legal consequence of Brexit is that the UK financial service providers lose their EU passport."
>
> However, he said there was a possibility that the EU could judge some of the UK rules as equivalent to its own, and said a good deal would facilitate as much market access as possible, while seeking to avoid a situation whereby the UK and the EU trade under WTO rules.[8]

When the UK Government published its ambitions for negotiations in the Brexit White Paper[9] in July 2018, it acknowledged that passporting was not possible, and that both the UK and EU would want to maintain "autonomy of decision-making and the ability to legislate for their own interests". It continued by outlining a proposed format for the future, referring to equivalence-based approaches but also noting their limitations in dealing with the depth of integration of the UK and wider EU financial services market:

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6 TheCityUK, TheCityUK responds to the UK's vote to leave the EU, 24 June 2016.

7 European Parliament, European Parliament resolution of 5 April 2017 on negotiations with the United Kingdom following its notification that it intends to withdraw from the European Union (2017/2593(RSP), para 25.

8 Martin Banks, "Barnier: Brexit means Brexit – everywhere", The Parliament Magazine, 17 November 2017.

9 HM Government, The Future Relationship Between the United Kingdom and the European Union Cm 9593; July 2018.

62. The EU has third country equivalence regimes which provide limited access for some of its third country partners to some areas of EU financial services markets. These regimes are not sufficient to deal with a third country whose financial markets are as deeply interconnected with the EU's as those of the UK are. In particular, the existing regimes do not provide for:

a. institutional dialogue, meaning there is no bilateral mechanism for the EU and the third country to discuss changes to their rules on financial services in order to maximise the chance of maintaining compatible rules, and to minimise the risks of regulatory arbitrage or threats to financial stability;

b. a mediated solution where equivalence is threatened by a divergence of rules or supervisory practices;

c. sufficient tools for reciprocal supervisory cooperation, information sharing, crisis procedures, or the supervision of crossborder financial market infrastructure;

d. some services, where clients in the UK and the EU currently benefit from integrated markets and cross-border business models. This would lead to unnecessary fragmentation of markets and increased costs to consumers and businesses; or

e. phased adjustments and careful management of the impacts of change, so that businesses face a predictable environment.

63. In this context, the UK proposes a new economic and regulatory arrangement with the EU in financial services. This would maintain the economic benefits of cross-border provision of the most important international financial services traded between the UK and the EU – those that generate the greatest economies of scale and scope – while preserving regulatory and supervisory cooperation, and maintaining financial stability, market integrity and consumer protection.

64. This new economic and regulatory arrangement would be based on the principle of autonomy for each party over decisions regarding access to its market, with a bilateral framework of treaty-based commitments to underpin the operation of the relationship, ensure transparency and stability, and promote cooperation. Such an arrangement would respect the regulatory autonomy of both parties, while ensuring decisions made by either party are implemented in line with agreed processes, and that provision is made for necessary consultation and collaboration between the parties.

65. As part of this, the existing autonomous frameworks for equivalence would need to be expanded, to reflect the fact that equivalence as it exists today is not sufficient in scope for the breadth of the interconnectedness of UK-EU financial services provision. […]

66. As the UK and the EU start from a position of identical rules and entwined supervisory frameworks, the UK proposes that there should be reciprocal recognition of equivalence under all existing third country regimes, taking effect at the end of the implementation period.[10]

[10] HM Government, The Future Relationship Between the United Kingdom and the European Union Cm 9593; July 2018.

Nevertheless, some in the financial sector expressed disappointment with this approach, with calls instead for a mutual recognition scheme. This could involve recognition that each party's standards are equivalent and could involve some sort of shared process or institution to agree those standards.[11] According to TheCityUK:

> The overriding issue for financial and related professional services firms is the ability to continue serving customers and clients. Mutual recognition would have been the best way to achieve this. It's therefore regrettable and frustrating that this approach has been dropped before even making it to the negotiating table. In hundreds of discussions across the EU, the industry has never come across an unanswerable technical or commercial barrier to this approach. The EU's objections have always been political.[12]

Meanwhile, the City of London Corporation noted:

> Today's Brexit white paper is a real blow for the UK's financial and related professional services sector.
>
> With looser trade ties to Europe, the financial and related professional services sector will be less able to create jobs, generate tax and support growth across the wider economy. It's that simple.
>
> The sector has been clear since the referendum: Equivalence in its current form is not fit for purpose so any "enhancements" to this regime would have to be substantial.[13]

Despite these aspirations and concerns, there was little apparent progress over the following months. In November 2018, negotiators agreed the Political Declaration setting out the Framework for the Future Relationship between the European Union and the United Kingdom. This Declaration was endorsed by EU leaders at a special meeting of the European Council on 25 November 2018.

At the time of writing, the Political Declaration is the most advanced statement of a joint view between the UK and the EU about potential future arrangements for trade in financial services.[14] It highlights the importance and value of cooperation, promoting the exploration of equivalence regimes as the way forward.

> 37. The Parties are committed to preserving financial stability, market integrity, investor and consumer protection and fair competition, while respecting the Parties' regulatory and decision-making autonomy, and their ability to take equivalence decisions in their own interest. This is without prejudice to the Parties' ability to adopt or maintain any measure where necessary for prudential reasons. The Parties agree to engage in close cooperation on regulatory and supervisory matters in international bodies.
>
> 38. Noting that both Parties will have equivalence frameworks in place that allow them to declare a third country's regulatory

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11 More detail is available in Commons Library Briefing, Future trade with the EU: Mutual recognition, CBP8384.
12 TheCityUK, TheCityUK responds to the government's Brexit White Paper, 12 July 2018.
13 The City of London, press release, 12 July 2018.
14 More detail is available in Commons Library Briefing, The Political Declaration on the Framework for Future EU-UK Relations,CBP8454.

> and supervisory regimes equivalent for relevant purposes, the Parties should start assessing equivalence with respect to each other under these frameworks as soon as possible after the United Kingdom's withdrawal from the Union, endeavouring to conclude these assessments before the end of June 2020. The Parties will keep their respective equivalence frameworks under review.
>
> 39. The Parties agree that close and structured cooperation on regulatory and supervisory matters is in their mutual interest. This cooperation should be grounded in the economic partnership and based on the principles of regulatory autonomy, transparency and stability. It should include transparency and appropriate consultation in the process of adoption, suspension and withdrawal of equivalence decisions, information exchange and consultation on regulatory initiatives and other issues of mutual interest, at both political and technical levels.[15]

In its EU Withdrawal Impact Assessment the Financial Conduct Authority (FCA) also raised the possibility of some form of enhanced arrangement:

> The UK and EU will both have the ability and common interest to find each other's regimes equivalent post exit, facilitating market access across a range of sectors. The declaration appropriately recognises that this must be in the context of both sides retaining autonomy over the exercise of their equivalence regimes. Therefore, equivalence assessments will need to be based on equivalence of outcomes as opposed to identical rulebooks. It will also be necessary to consider carefully the process and scope of equivalence as it currently exists, to ensure that it provides an adequate framework for cross border business in the future. We believe that there is substantial scope for development and improvement of the framework.
>
> The declaration also provides for close and structured supervisory and regulatory engagement, and the possibility for an enhanced relationship compared to a standard third country position. The FCA is committed to close cooperation with EU counterparts. If implemented, this could make it easier for us to continue to meet our objectives, and help manage cross border risks by ensuring that they can be identified early and managed effectively.[16]

The Political Declaration thus hinted at the possibility of new institutional arrangements that might lead to a more robust and transparent equivalence regime, but the aspirational nature of the Declaration means that it is not clear how far this might have gone and how far it would have satisfied stakeholders. Such questions were deferred to negotiations that would have taken place during the implementation period that would have followed ratification of the Withdrawal Agreement.

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[15] HM Government, Political Declaration setting out the Framework for the Future Relationship between the European Union and the United Kingdom, 25 November 2018.

[16] Financial Conduct Authority, EU Withdrawal Impact Assessment, November 2018, p5.

2.2 Establishing equivalence

The process of agreeing and maintaining equivalence is neither straightforward nor as thorough in its application as passporting. It can take time, be subject to wider technical or political concerns, and is tied to specified services and the maintenance of regulatory congruence between the two parties.

An article in *Bloomberg* included comments from the former UK Commissioner Jonathan Hill about what is involved making decisions about equivalence:

> **What's involved in an equivalence decision?**
>
> Equivalence refers to the European Commission's recognition that a country's rules and oversight of specific business lines are as tough as its own. This allows the EU to rely on firms' compliance with those frameworks, reducing overlaps on both sides as well as reducing capital costs for EU companies exposed to equivalent third countries.
>
> Most EU financial-services acts contain provisions for equivalence, including the updated markets rules known as MiFID II, which come into effect in 2018. Equivalence is also possible for some purposes in the EU's bank capital rules and in Solvency II, which governs the insurance industry.
>
> **How does it work?**
>
> To see how equivalence works, take the recent agreement the commission struck with the U.S. Commodity Futures Trading Commission on central counterparties.
>
> EU law, in this case the European Market Infrastructure Regulation, allows companies based outside the bloc to "provide clearing services to clearing members or trading venues" set up in the EU on two main conditions. First, the commission has to determine that the country's legal and supervisory systems are an "effective equivalent" to those in the EU; second, the company must be recognized by the bloc's markets regulator.
>
> The deal with the CFTC, announced in February, enabled companies such as Chicago-based CME Group Inc. to continue providing services to EU firms. Without it, traders would have faced higher EU capital requirements to clear swaps, futures and other derivatives in the U.S.
>
> **How long can equivalence talks take?**
>
> While the EU's equivalence talks with the CFTC were successful, they dragged on for nearly four years even though at issue was "one tiny subset of the whole financial services sector landscape," as Jonathan Hill, the EU's former financial-services chief, said in June. What's more, this was a case in which both sides "wanted to conclude it quickly," he said.
>
> "The bureaucratic process of gaining equivalence is complex," said Edward Chan, banking partner at Linklaters LLP in London. The process is "likely to take a minimum of six months upon exit," he said. The European Commission is under "no obligation" to grant equivalence, and "the decision can be time-bound and

> reversed, so, although it is not meant to be a political process, it is likely that political considerations will influence this decision."[17]

EU financial services law includes around 40 areas for equivalence decisions. As of July 2019, the Commission had taken "over 280 equivalence decisions for more than 30 countries, across various parts of the financial industry".[18]

A 2016 report from Open Europe explained the political process underlying the granting of equivalence:

> In theory, having been a member of the EU, the UK would have no problem obtaining equivalence on day one after Brexit.
>
> However, if EU regulations change over time the UK would have to adapt its own legislation to maintain continued market access for its financial services sector. This could become increasingly challenging if in future, with the UK no longer involved in the law-making process, the EU takes a more protectionist approach to financial regulation. Although in that scenario being able to diverge from onerous regulations may in fact prove a competitive advantage for the UK, even if access is lost.[19]

The Open Europe report stated that the EU had never actually withdrawn from an equivalence agreement, but that situation has now changed. The European Commission confirmed in July 2019 that:

> [T]he Commission has for the first time repealed existing decisions for Argentina, Australia, Brazil, Canada, and Singapore, as these jurisdictions could no longer meet the standards set by the EU Credit Rating Agencies after its amendment in 2013. The countries decided, after discussions with the Commission, not to implement the necessary legislative adjustments given the limited scale of activity to be covered.[20]

Decisions about equivalence may also explicitly depend on wider political considerations. In 2017, the Commission granted equivalence for stock markets to a range of countries, but the decision for Switzerland would only last for a year. Extensions were made dependant on "progress made towards the signature of an agreement establishing [a new] common institutional framework" that would replace a wide range of bilateral agreements.[21] In June 2019, the EU refused to continue the recognition of equivalence.[22] The decision not to renew was linked to the EU's frustration at Switzerland's delay and attempt to renegotiate certain elements of the institutional framework. According to the *Financial Times*, the EU Commissioner "wrote that any

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17 *Bloomberg*, Banks in U.K. Eyeing EU Market May Find Equivalence Cold Comfort, 31 August 2016.

18 European Commission, Press release, Commission sets out its equivalence policy with non-EU countries, 29 July 2019.

19 Open Europe, How the UK's financial services sector can continue thriving after Brexit, 2016, p33.

20 European Commission, Financial services: Commission sets out its equivalence policy with non-EU countries, 29 July 2019.

21 Bruegel, The consequences of Switzerland's lost equivalence status, 25 July 2019

22 Financial Times, "EU-based traders caught in Swiss 'equivalence' spat", 30 June 2019.

attempt to soften the EU's internal market rules would not be accepted 'especially in what is probably the decisive phase regarding Brexit'."[23]

Nevertheless, in July 2019 the EU published a Communication[24] that sets out its "comprehensive approach" to equivalence, taking account of how "recent legislative improvements" support decisions about granting equivalence:

> The EU is firmly committed to promoting open, fair and efficient financial markets that operate within rigorous prudential and conduct frameworks. Equivalence is one of the key instruments at the EU's disposal in furthering that goal in the external dimension of the internal market. This is because it fosters coherence and mutual compatibility between the relevant parts of the EU framework and the corresponding rules in third countries. As a result, the EU equivalence policy satisfies three objectives:
>
> - it reconciles the need for financial stability and investor protection in the EU, on the one hand, with the benefits of maintaining an open and globally integrated EU financial market on the other;
> - it is pivotal in promoting regulatory convergence around international standards;
> - it is a major trigger for establishing or upgrading supervisory cooperation with the relevant third-country partners.[25]

[23] Financial Times, Brussels threatens to cut off Swiss stocks trading access, 19 June 2019.
[24] European Commission, Press release, Commission sets out its equivalence policy with non-EU countries, 29 July 2019.
[25] European Commission, Communication from the Commission: Equivalence in the area of financial service, 29 July 2019.

3. UK legislative preparation

Parliament has made provisions to transfer EU law on financial services into UK law up to the point of departure from the EU. A further Bill would have facilitated continued alignment in the event of a no-deal exit, but the Government has so far not scheduled the remaining stages of the Bill. This means that there are currently no other mechanisms to implement upcoming EU rules on financial services after exit without passing primary legislation, a situation that could complicate obtaining and retaining equivalence.

3.1 The European Union (Withdrawal) Act 2018

Most financial services regulation is made at EU level. It is either directly applicable or transposed into domestic law by secondary legislation. In preparation for leaving the EU, the *European Union (Withdrawal) Act 2018* (*EUWA*) incorporated and adapted all EU law on the day of exit into UK law so that existing regulations continue to work after Brexit.

Individual rules are adapted and incorporated by HM Treasury's programme of secondary legislation:

> This work involves making statutory instruments (SIs) under the European Union (Withdrawal) Act to prevent, remedy or mitigate any failure of EU law to operate effectively after the UK leaves the EU. These SIs are not intended to make policy changes, other than those necessary to reflect the UK's new position outside the EU, and to smooth the transition to this situation.[26]

If the UK had ratified the May Government's Withdrawal Agreement, it would have entered an implementation period until 31 December 2020, during which EU law would have continued to apply. The UK would have continued to implement EU financial services regulation through secondary legislation.

3.2 The Financial Services (Implementation of Legislation) Bill 2017-19

The *Financial Services (Implementation of Legislation) Bill 2017-19* would empower the UK Government to transpose a number of upcoming EU financial regulations after exit if the UK were to leave without a deal.

The Bill applies to "in-flight files" – that is, items of EU financial services legislation that have either been adopted by the EU but will not be implemented before Brexit, or that are nearly settled and will be adopted shortly after Brexit.[27] The Bill would give the Treasury the

[26] HM Treasury, Financial services legislation under the EU (Withdrawal) Act 2018, 21 February 2019

[27] HM Treasury, Financial Services (Implementation of Legislation) Bill: updated policy note, February 2019 includes a list of in-flight files; this may be subject to further updating.

power to create corresponding or similar UK regulations, taking account of adjustments reflecting the UK's new position outside the EU.

Part of the logic underlying the Bill is that the UK had a leading role in shaping the content of the files. Lord Bates, speaking for the Government, explained that these files "have been settled while the UK has been an EU member and has been around the negotiating table at all stages with a full voice".[28] But keeping pace with EU rules would also support the pursuit and retention of equivalence.

The Bill would allow the Treasury such powers for two years from the point of exit, and any Statutory Instruments would be subject to a vote in both Houses. The Treasury would have to produce six-monthly reports on the use of the power.[29] For more information about the Bill, please see our briefing paper, Financial Services (Implementation of Legislation) Bill 2017-19 (CBP-8493).

The Government withdrew the Bill from the business of the day in March 2019, and has not scheduled the remaining stages. MPs had tabled an amendment that would force the British Overseas Territories and Crown Dependencies to open their registers of the beneficial ownership to the public by the end of 2020.[30][31] The Bill will fall if it is not passed during the current parliamentary session.

[28] HL Deb 29 January 2019 c1019.
[29] All Bill documents are available at *Financial Services (Implementation of Legislation) Bill [HL] 2017-19*.
[30] HC Deb 4 March 2019 cc663-6.
[31] House of Commons Library, Registers of beneficial ownership (CBP-8259).

4. If there is no deal

The biggest challenge that a no deal exit creates for financial services is the sudden loss of passports (see section 2.1). This section looks at the short-term arrangements put in place to avoid a cliff edge and allow for an orderly transition to third-country status.

The Government's no-deal notices and guidance for financial services are collated in Banking, insurance and other financial services if there's no Brexit deal. The main points from these notices and other sources is summarised below.

4.1 What happens?

In the event of no deal, the Government will allow EU firms to continue their activities in the UK for a limited period (see section 4.3). Firms wishing to continue doing business in the UK in the longer term will be able to use this period to obtain full authorisation (or recognition) from UK regulators without disruption to their business.[32]

In August 2018, the Government published its analysis of what happens to financial services if there is no deal, one of a series of technical notices that looked at different sectors. The analysis makes much of the fact that, although the UK will be treated as a third country by the EEA (and vice versa), it is committed to developing arrangements to ensure continuity:

> The government has confirmed that there will be instances where we diverge from this approach in order to ensure that a functioning legislative regime is in place, to minimise disruption and avoid material unintended consequences for the continuity of financial services provision, to protect the existing rights of UK consumers, or to ensure financial stability.
>
> One key example of this is the government's commitment to introduce a Temporary Permissions Regime (TPR) that will allow EEA firms currently passporting into the UK to continue operating in the UK for up to three years after exit, while they apply for full authorisation from UK regulators. The government has published in draft the legislation that will deliver the TPR and the financial regulators, the Financial Conduct Authority (FCA) has published its approach to implementing the TPR and the Prudential Regulation Authority (PRA) has also set out its expectations for the TPR. Similar temporary regimes will be provided for EEA electronic money and payment institutions, registered account information service providers, and EEA funds that are marketed into the UK.
>
> […]
>
> The government has already laid draft secondary legislation that will establish a temporary recognition regime (TRR) for central counterparties (CCPs). This regime will allow non-UK CCPs to continue to provide clearing services to UK firms for a period of up to three years while those CCPs apply for recognition in the

32 Bank of England, Bank of England's approach to financial services legislation under the European Union (Withdrawal) Act, 27 June 2018.

> UK. The Bank of England has published further details on the approach to recognising non-UK CCPs.
>
> The government will also be bringing forward legislation to deliver transitional arrangements for:
>
> - Central Securities Depositories
> - Credit Rating Agencies
> - Trade Repositories
> - Data Reporting Service Providers
> - Systems currently under the Settlement Finality Directive
> - Depositaries for authorised funds.
>
> The government will transfer functions currently carried out by European bodies to the appropriate UK body.[33]

The Notice set out the consequences of no deal, highlighting particular effects on UK customers of EEA firms and EEA customers of UK firms as a result of the loss of passporting.

> For example, the UK is a major centre for investment banking in Europe, with UK investment banks providing investment services and funding through capital markets to business clients across the EU. In the absence of EU action, EEA clients will no longer be able to use the services of UK-based investment banks, and UK-based investment banks may be unable to service existing cross-border contracts.[34]

HM Treasury's approach to financial services legislation under the European Union (Withdrawal) Act (August 2018) also explained what would happen if there is no deal. As a third country, UK-based financial services would lose their automatic access to the EU and vice versa. It noted though that:

> In some areas, correcting deficiencies to reflect this environment would be relatively straightforward. The UK's world-leading financial sector is overseen by HM Treasury and underpinned by a strong legislative framework with world-class regulators (the Bank of England/Prudential Regulation Authority and Financial Conduct Authority). This means that the responsibilities of EU bodies could be re-assigned efficiently and effectively, providing firms, funds and their customers with confidence after exit.[35]

4.2 Who regulates?

In the event of no deal, regulatory functions carried out by the EU will be transferred to UK bodies responsible for regulating financial services. The Government said:

> In leaving the EU without a deal, many functions currently carried out at an EU level would cease to apply to the UK and would need to be provided for in the UK's regulatory regime. HM Treasury's onshoring work involves allocating these EU functions to the appropriate UK bodies. In this scenario, HM Treasury

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33 HM Government, Banking, insurance and other financial services if there's no Brexit deal: technical notice on financial services regulatory framework, 8 January 2019.

34 Ibid.

35 HM Treasury, HM Treasury's Approach to financial services legislation under the European Union (Withdrawal) Act, August 2018, p4.

> proposes to follow the model outlined in FSMA and allocate functions to UK regulators in a way which is consistent with the responsibilities already conferred on them by Parliament, thus providing certainty and continuity for firms.
>
> Further information about how HM Treasury proposes to allocate responsibilities between HM Treasury and the financial services regulators in this scenario can be found in the draft Financial Regulators' Powers (Technical Standards) (Amendment etc.) (EU Exit) Regulations 2018 and accompanying explanatory note, published in April 2018.
>
> Additionally, HM Treasury has confirmed that in this scenario it intends to transfer supervisory powers to the FCA to regulate credit ratings agencies and trade repositories currently supervised at the European level by the European Securities and Markets Authority (ESMA), and it intends to give functions and powers in relation to non-UK central counterparties and non-UK central securities depositories, also currently exercised by ESMA, to the Bank of England.[36]

The Bank of England, the Prudential Regulation Authority, the Financial Conduct Authority and the Payment Systems Regulator are named as the "appropriate regulators" in Regulation 2 of the *Financial Regulators' Powers (Technical Standards etc.) (Amendment etc.) (EU Exit) Regulations 2018*, while the Schedule lists the precise EU powers and responsibilities that they will assume.

4.3 Temporary permissions regime

In December 2017, the Government announced its intention to introduce a temporary permissions regime (TPR) to allow EEA firms to continue operating in the UK for a limited period after the UK has left the EU without a deal.

This temporary regime would be bolstered by giving the main regulators the power to implement changes to their rulebooks to support the effectiveness of the TPR in line with eventual legislation.

The TPR will allow EEA firms currently passporting into the UK to continue operating in the UK for up to three years after exit. During that time, these firms can apply for full authorisation from UK regulators.

The EEA Passport Rights (Amendment, etc., and Transitional Provisions) (EU Exit) Regulations 2018 that would deliver the TPR were made on 6 November 2018. As the main regulators, the Financial Conduct Authority (FCA) published its approach to implementing the TPR,[37] while the Bank of England has set out its expectations for the initiative.[38]

But this initiative is one-way. The Government reiterates the importance of reciprocal regulatory action on the part of the EU:

> However, the UK authorities are not able through unilateral action to fully address risks to the EEA customers of UK firms currently providing services into the EEA using the financial services

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[36] HM Treasury, HM Treasury's Approach to financial services legislation under the European Union (Withdrawal) Act, 9 August 2018, paras 1.24 – 1.26.

[37] Financial Conduct Authority, The temporary permissions regime for inbound passporting EEA firms and funds, 31 July 2019.

[38] Bank of England, Temporary permissions and recognition regimes, 24 July 2018.

> passport. The government is committed to working with EU partners to identify and address such risks.
>
> Many UK financial services firms who currently passport into the EEA are taking steps to ensure that they could continue to operate after exit, for example by establishing a new EU-authorised subsidiary. This would allow the UK firm to offer new services after exit through its EEA subsidiary, and in some cases existing contracts could be transferred to the new entity.[39]

In many cases, individual Member States – rather than the EU overall – are responsible for implementing TPR arrangements. The agreements are generally restricted to very specific services. By February 2019, France, Germany, Italy and the Netherlands – among others – had changed laws in order to allow UK investment companies to continue operating.[40] Such responses are however inevitably piecemeal and changeable. A summary of arrangements in place is available.[41]

4.4 Financial stability risks related to derivatives

Derivatives are financial contracts used to manage risk, but also to speculate.[42] Managing "life-cycle events" (decision points in derivative contracts) involves performing regulated activities and so will be affected by Brexit decisions. Speaking to the Treasury Committee in July 2018, the Governor outlined the problem, explaining that firms may no longer be permitted to manage these life-cycle events in an unmitigated no-deal scenario:

> The crucial point here is that on the day of leaving, the contract can still be serviced; however, life-cycle events will start to accumulate and, arguably, they will accumulate quite rapidly in the event of a cliff-edge Brexit because one would reasonably expect the volatility in markets to go up. How big is that potential risk? We have done the due diligence on that. For a mid-size firm there are about 1,000 life-cycle events a month. For a large derivative counterparty, there are up to 250,000 a week. If you think about it in the world of derivatives hedging underlying positions, with the inability to conduct these life-cycle events and an environment where there is volatility, the risk – the inability to dynamically hedge – increases with time, and you see a financial stability risk developing fairly quickly, in our opinion. We shared that opinion publicly through the FSR and directly with our counterparts in the EU.[43]

The issue relates to cross-border clearing houses. A central counterparty (CCP) clearing house is a financial institution that facilitates the

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[39] HM Government, Banking, insurance and other financial services if there's no Brexit deal: technical notice on financial services regulatory framework, 8 January 2019.

[40] Financial Times, EU governments provide Brexit relief for asset managers, 19 February 2019.

[41] See, for instance, Regulation Tomorrow, Brexit: Doing business in the EU – Updated. Accessed 7 August 2019.

[42] They are "derivative" in that they derive their value from other assets or rates that serve as a reference. For example, an interest rate swap is a derivative that allows a firm to fix the interest rate it pays on a variable loan, or indeed to vary the rate on a fixed loan. For further information, see Investopedia, Derivative.

[43] Treasury Committee. Oral evidence: Bank of England Financial Stability Reports, HC681, 17 July 2018.

settlement (or clearance) of financial contracts such as derivatives. The clearing house stands between two clearing firms (also known as member firms or participants). The CCP reduces the risk and consequences of participants defaulting on their obligations, so making these transactions cheaper and safer for traders.

4.5 Temporary recognition regime

As is the case with the temporary permissions regime discussed in section 4.3, the UK will establish a temporary **recognition** regime (TRR) for EEA-based central counterparties (CCPs). This will allow EEA CCPs to continue to provide clearing services to UK firms for a period of up to three years while those CCPs apply for recognition in the UK. The Bank of England has published further details on the approach to recognising non-UK CCPs.[44]

The effect of a no deal Brexit on outstanding derivatives contracts cleared via UK CCPs would be financially destabilising, for the UK but even more so for the EU, as set out in the Bank of England's Financial Stability Report (June 2018):

> EEA clearing members and their clients currently rely heavily on CCPs based in the UK. The ECB estimates that UK CCPs clear approximately 90% of euro-denominated interest rate swaps used by euro-area customers. (p12)

The Governor explained that unlike the UK, the EU had not yet come up with a temporary recognition regime for UK CCPs:

> … as it stands at present, the large, UK-based clearing houses would no longer be authorised clearing houses by the EU following the Brexit date. Therefore, the actions of European counterparties that had cleared in those clearing houses would be ultra vires; they would not be authorised to use those clearing houses. Those clearing houses would know that in advance and so the European counterparties would have to close out those positions in advance. The question is how rapidly that could be done. The orders of magnitude are much higher – it is a notional £60 trillion-plus of exposure – than they are in the uncleared space. That process, which the Bank of England oversees as the regulator of these clearing houses, would have to begin prior to the Brexit date.
>
> I want to make two final points. First, the UK Government have signalled their intention and developed statutory instruments, which they will lay before Parliament as soon as is practical. Given the timing of the summer recess, that is likely to be in the fall, but it will be done in a timely way. Those statutory instruments will solve the UK side of this issue – both authorisation of EU CCPs and authorisation of the EU counterparties. The European Union has not yet indicated a solution to this.[45]

Four months later, though, the European Commission announced that it would indeed grant temporary recognition to UK CCPs in the event of

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44 Bank of England, The Bank of England's approach to the authorisation and supervision of international banks, insurers and central counterparties, 20 December 2017.

45 Treasury Committee. Oral evidence: Bank of England Financial Stability Reports, C681, 17 July 2018.

no deal.[46] The European Securities and Markets Authority (ESMA) explained:

> The European Securities and Markets Authority (ESMA) is publishing this Public Statement to address the risks of a no-deal Brexit scenario in the area of central clearing. The ESMA Board of Supervisors supports the continued access to UK CCPs to limit the risk of disruption in central clearing and to avoid negatively impacting EU financial market stability.[47]

A further statement on 19 December 2018 clarified their plans for recognition, although whether arrangements would be more than the bare minimum to safeguard financial stability would be a matter for negotiations.[48]

The combination of no passporting and the derivatives issue is deeply troublesome for the insurance industry too. The Association of British Insurers (ABI) indicated that coordination between the UK and EU to avoid a "cliff edge" would be "imperative". A briefing from the Association of British Insurers set out the threat to the continuity of contracts:

> - It is critical that the UK and EU implement the transitional period that was agreed at a political level at the European Council meeting in March 2018. Furthermore, it is also important for UK and EU regulators to issue commitments about the future treatment of these contracts to act as a regulatory 'back stop' in the event that the transitional period fails to materialise.
> - Any UK/EU solution should also be underpinned by ongoing supervisory cooperation between UK and EU regulators. The new European Central Bank (ECB) and the Bank of England (BoE) technical working group on risk management, announced on 27 April 2018, would be an ideal forum to discuss solutions to this issue.
> - The early announcement of grandfathering arrangements, either for a time-limited period or potentially until maturity, would allow for contract continuity which will deliver the best results for UK and EEA customers, as well as European competitiveness more broadly.[49]

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[46] European Commission, Preparing for the withdrawal of the United Kingdom from the European Union on 30 March 2019: a Contingency Action Plan, 13 November 2018.

[47] ESMA, Managing risks of a no-deal Brexit in the area of central clearing, 23 November 2018

[48] ESMA, ESMA is ready to review UK CCPs' and CSDs' recognition applications for a no-deal Brexit scenario, 19 December 2018.

[49] Better Regulation, TheCityUK: Continuity of cross-border financial contracts post-Brexit, 20 June 2018.

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